CANADIAN NATIONAL 1996 ANNUAL REPORT

Canadian National's first full year as an investor-owned, market-driven company saw many significant accomplishments that improved service and reduced costs. During 1996 we:

- **Achieved a full year operating ratio (excluding special charges) of 85.3 percent, better than our target of 85.6 and fully 4 points better than the previous year.**

- **Produced $610 million in operating income (excluding special charges), a 39 percent improvement over 1995.**

- **Opened our centralized Customer Support Centre in Winnipeg.**

- **Added 105 new high-horsepower locomotives to our mainline fleet.**

- **Established the "Superior Connection" into Chicago through strategic alliances with U.S. railroads.**

- **Negotiated a locomotive maintenance agreement with General Motors Diesel Division that includes performance guarantees.**

- **Achieved $30 million reduction in the cost of materials and services.**

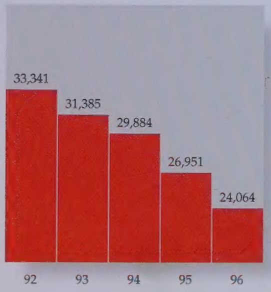
Contents

Canadian National Railway Company

$ in millions, except per share data, or unless otherwise indicated	1996	1995	1994	1993	1992
Financial results					
Revenues	$ 4,159	$ 4,098	$ 4,305	$ 3,956	$ 3,897
Operating expenses excluding special charges	3,549	3,658	3,848	3,754	3,785
Special charges	381	1,453	–	49	951
Operating income (loss)	229	(1,013)	457	153	(839)
Operating income excluding special charges	610	440	457	202	112
Interest expense – net	114	198	196	198	202
Other income	20	100	27	9	(1)
Income (loss) from continuing operations	124	(1,092)	264	(61)	(1,019)
Income (loss) from continuing operations excluding special charges	505	361	264	(12)	(68)
Capital expenditures	496	326	539	442	308
Earnings (loss) per share from continuing operations	1.46	(13.57)	3.30	(0.76)	(12.74)
Earnings (loss) per share from continuing operations excluding special charges	5.95	4.49	3.30	(0.15)	(0.85)
Other statistical highlights					
Rail operating ratio excluding special charges *(%)*	85.3	89.3	89.4	94.9	97.1
Route miles *(includes Canada and the U.S.)*	17,124	17,918	18,414	18,851	19,522
Carloads *(thousands)*	2,315	2,295	2,354	2,182	2,136
Gross ton miles *(millions)*	208,328	204,143	211,805	193,797	189,140
Revenue ton miles *(millions)*	107,470	105,487	109,004	98,650	97,462
Rail employees *(average for the year)*	24,064	26,951	29,884	31,385	33,341
Diesel fuel consumed *(Canadian gallons in millions)*	259	256	266	250	247
Average price per Canadian gallon *(dollars)*	$ 1.22	$ 1.08	$ 1.03	$ 1.04	$ 1.04

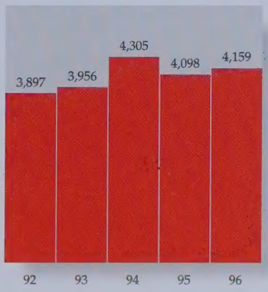
Employees

Average for the year



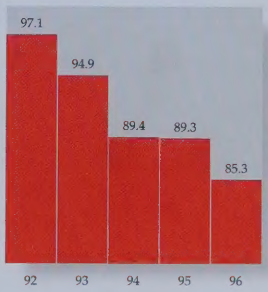
Revenues

Dollars in millions



Operating ratio (%)

Excluding special charges



CANADIAN NATIONAL AT A GLANCE

Canadian National Railway Company (CN) is North America's sixth-largest railroad, based upon 1996 revenues of more than $4 billion. CN operates more than 17,000 route miles of track in Canada and the United States. It is Canada's largest, and North America's only, transcontinental railroad system.

CN's rail network serves all five of Canada's major ports: Halifax, Montreal, Thunder Bay, Prince Rupert, and Vancouver, and includes strategic connections to the United States, the most important of which is the Chicago gateway.

CN's revenues derive from the movement of a diversified and balanced portfolio of commodities, categorized into six business groups: industrial products; forest products; grain and grain products; coal, sulphur, and fertilizers; intermodal; and automotive.

Thirty-nine percent of our revenues come from transborder and domestic U.S. traffic. Another 27 percent of CN revenues derive from overseas traffic, primarily Asia and the Pacific Rim countries. The remaining 34 percent of revenues are derived from Canadian domestic traffic.

At the end of 1996, CN had 21,589 active rail employees across Canada and in the United States.

INDUSTRIAL PRODUCTS

One of CN's fastest-growing business groups, industrial products includes a wide range of commodities such as chemicals and plastics, petroleum and gas products, metals, and construction materials. These products are destined to overseas export terminals, or to customers via CN's eastern and western corridors to Chicago. Our access to northern Alberta's natural gas production centres and virtually all of Canada's largest plastics producers, and exclusive access to major aluminum smelters in Quebec and British Columbia, are key factors in CN's competitive advantage.

1996 Percentage of revenues

1996 Data

Revenues *(In millions)*	$866
Revenue ton miles *(In millions)*	22,551
Freight revenues per revenue ton mile *(In cents)*	3.84

FOREST PRODUCTS

CN's forest products group comprises four commodities: lumber, fibres, paper, and panels. Most forest products traffic moves either via CN's main corridor from western Canada to Chicago, or from northeastern Canada to midwestern and eastern interchange points with major U.S. railroads, destined for the midwestern and southeastern United States. In both eastern and western Canada, CN has superior access to the major fibre-producing regions that make Canada the world's largest exporter of forest products.

1996 Percentage of revenues

1996 Data

Revenues *(In millions)*	$790
Revenue ton miles *(In millions)*	21,297
Freight revenues per revenue ton mile *(In cents)*	3.71

GRAIN AND GRAIN PRODUCTS

Canadian National's grain and grain products business consists of three primary commodities, for the most part grown or processed in western Canada: wheat, barley, and canola. More than 65 percent of traffic in this business segment moves from western Canada to terminals at Vancouver and Prince Rupert on the West Coast, and Thunder Bay on Lake Superior, for overseas export. The balance of traffic moves to a wide variety of North American destinations.

1996 Percentage of revenues

1996 Data

Revenues *(In millions)*	$570
Revenue ton miles *(In millions)*	20,755
Freight revenues per revenue ton mile *(In cents)*	2.75

COAL, SULPHUR, AND FERTILIZERS

The majority of traffic in this segment originates in western Canada and moves overseas from ports in British Columbia or is exported to the United States. CN handles primarily metallurgical coal, used for steel production offshore, primarily in Japan, as well as for utilities in North America and abroad. Canadian sulphur and potash are exported to a large number of nations for the production of fertilizers.

1996 Percentage of revenues

1996 Data

Revenues *(In millions)*	$622
Revenue ton miles *(In millions)*	23,730
Freight revenues per revenue ton mile *(In cents)*	2.62

INTERMODAL

CN's intermodal group consists of two product segments: domestic and overseas. The domestic group handles consumer products and manufactured goods, and unlike most U.S. railroads, provides complete door to door service. It is also responsible for carload freight forward traffic, and for providing line haul services for motor carrier partners. The overseas segment handles import-export containers for ocean shipping companies. The group's main traffic flows are between Halifax and Chicago, between eastern and western Canada, and between Vancouver and Chicago, the fastest growing corridor.

1996 Percentage of revenues

1996 Data

Revenues *(In millions)*	$710
Revenue ton miles *(In millions)*	16,507
Freight revenues per revenue ton mile *(In cents)*	4.30

AUTOMOTIVE

Canadian National is a leading carrier of automotive products originating in southwestern Ontario and Michigan, a region that accounts for some 40 percent of all vehicles produced in Canada and the United States. CN has direct access to 10 of the 14 auto assembly plants in Canada and eight of the 17 assembly plants in Michigan. The railroad moves finished vehicles and parts within both Canada and the United States, and in both directions across the Canada-U.S. border.

1996 Percentage of revenues

1996 Data

Revenues *(In millions)*	$402
Revenue ton miles *(In millions)*	2,630
Freight revenues per revenue ton mile *(In cents)*	15.29

Canadian National Railway Company

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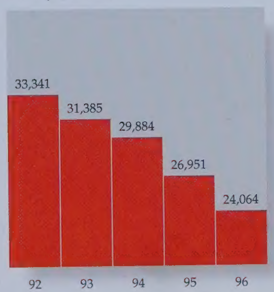
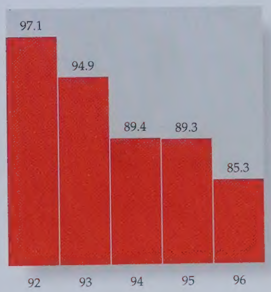


Revenues

Dollars in millions

Operating ratio (%)

Excluding special charges



Canadian National is achieving its goal to become the best railroad in North America through four concerted, comprehensive strategies:

Grow our business.

We are creating profitable, top-line growth by partnering with customers to continuously improve the quality and scope of our services; by cementing strategic alliances with other carriers to extend our reach in the U.S., Canada, and beyond; and by positioning ourselves to take advantage of new opportunities in a dynamic North American marketplace.

Deliver on customer commitments.

We are achieving breakthrough improvements in service reliability and customer satisfaction by using customer goals and industry-leading technology to balance our resources with customer needs.

Be cost competitive.

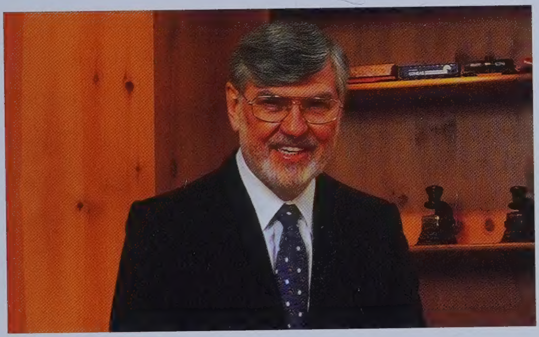
We will continue to contain our costs, not just by downsizing and centralizing, but also through innovative purchasing tactics and improved asset utilization.

Concentrate on what we do best.

We will focus our energies and resources on doing what we do best: operate a long-haul rail network. We will continue to shed low value-added activities and unproductive, non-core assets and concentrate on the safe, efficient, and reliable transport of our customers' goods.

Nineteen ninety-six was a remarkable year of progress and accomplishment for Canadian National. Through the strong leadership of our management team and the extraordinary dedication of every employee, CN met or exceeded every goal we set for 1996. We now have a strong, competitive platform on which to build for the future.

Our 1996 business plan proved an exceptionally successful blueprint in a highly competitive marketplace. The 1997 business plan continues our corporate direction, setting aggressive new goals that will provide added value for our customers and shareholders.



David McLean

Mrs. Jean Forest resigned from the board of directors upon her appointment to the Senate of Canada. We will miss her wise counsel, but wish her well in her new responsibilities. During 1996, the composition of our board continued to evolve with the addition of three new directors: Michael Armellino from New York, New York, a limited partner of Goldman Sachs; James Gray from Calgary, Alberta, president and chief executive officer of Canadian Hunter; and the Honourable Edward Lumley, P.C., from South Lancaster, Ontario, vice-chairman of Nesbitt Burns. I believe that our board has excellent depth and all the ability, judgment, and experience required to guide CN on its future course.

This is truly a new CN. Across the system, there is a strong sense of excitement, shared commitment, and singleness of purpose. I know that we will continue to meet the challenges ahead with energy and enthusiasm, as we pursue our goal of becoming the best North American railroad.

I wish to take this opportunity to express my gratitude to the board of directors, to CN's management team, and to each employee for the part each of you played in making 1996 such an unequivocal success. My thanks also extend to our shareholders for the support you have provided over the year. I am certain we will continue to justify your confidence in the future of CN.

Sincerely,

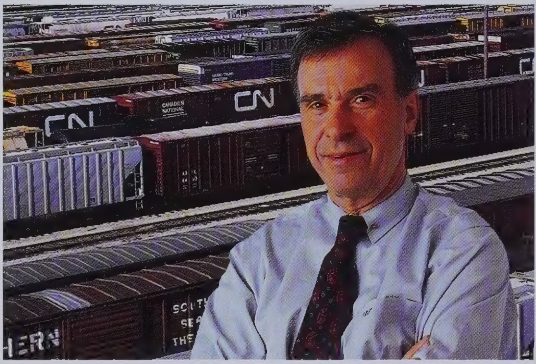
David McLean

David McLean
Chairman of the Board of Directors

I am pleased and proud of our 1996 performance. Through the vision, skills, and hard work of every CN employee, we have had the best year in our history. Canadian National achieved or surpassed every goal we set for 1996.

Financial performance in 1996 was the strongest ever. Income from continuing operations, excluding special charges, was $505 million, or $5.95 per share, a 40 percent increase over last year's $361 million, or $4.49 per share. 1996 operating income, excluding special charges, was $610 million, compared to $440 million in 1995.

Full-year revenues for 1996 were $4.2 billion, an increase of 1.5 percent over $4.1 billion a year ago. Our continued drive to reduce expenses brought our 1996 total, excluding special charges, to $3.5 billion, 3 percent less than 1995. Strong performance in both revenue and expense areas brought our operating ratio (excluding special charges) to 85.3 percent, 4 points better than the 89.3 percent (excluding special charges) for 1995. This surpasses our goal for the year of 85.6 percent.


Paul M. Tellier

Yes, 1996 performance was excellent and represents a critical milestone. But I am not satisfied. The turnaround is not complete.

No railroad made swifter progress in improving its operating ratio in the period since 1992. No Canadian company has undergone such profound change in so short a time.

Yet even as we change, the rail industry is changing as rapidly, and the bar is continuously raised. Mega-mergers are changing the face of our competition, making it stronger and more efficient. By the end of the century, our competitors south of the border will more than likely achieve operating ratios in the low 70s. Although our Initial Public Offering outlined an operating ratio goal of 82 by 2000, clearly we must do better if we are to remain competitive in the global marketplace.

I strongly believe we can do this. This is why our 1997 business plan establishes new, more aggressive goals to grow our business, to improve customer service, and to operate more efficiently and safely.

Our previous operating ratio target of 84.4 percent for 1997 will no longer suffice. Nor will our target of 82 percent for 2000. For 1997 CN's new goal is 83 percent and we will aim to be below 80 percent in the year 2000. Ambitious goals? Perhaps, but I am convinced that they must be achieved.

Indeed, as I look to the merger trends that are remaking the face of the industry in the United States, I believe we must try to do even better. For that reason, I have set out a vision of a CN with $1 billion of operating income at the turn of the century. This is an enormous challenge for all of us. And we are currently working on the initiatives we will need to break through to this higher level of financial performance.

We are building a new CN by improving our service. Now that we are bringing costs into line, this is our most important task for 1997 and beyond. We must get better at serving our customers.

One of the key elements in achieving the very best in customer service is our commitment to scheduled railroad operations. Our Service Reliability Strategy (SRS) gives us the technological platform necessary to operate a scheduled railroad. Implementation of SRS was completed during 1996. We can now balance customer demands with our own resources to effectively plan and predict the movement of trains and shipments within a defined time period – currently 48 hours. This will be extended to 72 hours by the end of 1997.

Our 1997 business plan intensifies CN's drive to be the best in North America, increasing goals set in our Initial Public Offering.

Nineteen ninety-seven will see a continuation of our intensified focus on safety. We are currently the third-safest railroad in North America, and we intend to be the best. In 1996, we revitalized our safety programs and practices through an aggressive 14-point plan that gives us all the tools we need to support a strong improvement in our safety performance. And we are the first railroad to appoint a safety ombudsman.

We are building a new CN by bringing the size of our labour force into line with our revenues and competition and by pursuing other, non-labour cost reductions. The innovative concept of supply chain management allowed us to reduce costs related to the acquisition of materials and services by more than $30 million in 1996.

In order to effectively compete in a dynamic marketplace and bring long-term shareholder value, we must surpass the goals we set a year ago. I am very confident we will succeed, as we continue to build on our successes and meet the demands of the marketplace.

Our accomplishments so far have meant a profound change in our corporate culture. Change is not always easy. But I am very proud of the fact that, faced with this challenge, we pulled together to do what we had to do. I truly appreciate the commitment and focus shown at every level of the organization, from the shop floor to the executive suite. We could not have come as far as we did without the dedication, hard work, and sacrifice of CN employees and their families.

I must also express my appreciation to our shareholders for the tremendous support they have shown during our first year as a publicly traded company. They have my promise that we will not be satisfied until we are the best railroad in North America, delivering consistent, reliable customer service and long-term shareholder value.

Yours sincerely,

Tellier

Paul M. Tellier
President and Chief Executive Officer

During its first full year as a publicly traded company, CN delivered on the commitment made at the time of its Initial Public Offering to reduce costs, improve service, and position our business for long-term growth. Following is a report of progress and activities in seven key areas during 1996: cost reduction, productivity, network rationalization, strategic investments, service enhancement, safety, and the environment.

COST REDUCTION

At Canadian National, the measure of our success in achieving our objectives during 1996 can be seen in the fact that we improved our operating ratio (excluding special charges) to 85.3, fully 4 points below our 1995 operating ratio (excluding special charges) of 89.3.

During the year, we reached an agreement with General Motors Diesel Division of London, Ontario, covering the maintenance and repair of CN's core fleet of 511 high-horsepower locomotives. GM technical representatives supervise maintenance and repair of the locomotives at CN's locomotive reliability centres in Edmonton and Toronto. The work itself is done by CN employees.

This maintenance contract will result in an annual reduction of about $10 million in maintenance expense and provides for guarantees in the reliability and availability of our core fleet. The contract calls for continuous improvement in future years.

In 1996, we consolidated three under-utilized locomotive and six heavy equipment railcar maintenance facilities in eastern Canada into Toronto, for annualized savings in excess of $30 million. We also consolidated CN's three work equipment maintenance shops into Winnipeg. The acquisition of sophisticated, low-maintenance equipment, combined with additional repairs in the field, has reduced the level of shop maintenance. As a result, the productivity and reliability of CN's work equipment function increased, which resulted in annual savings of about $7 million.

Beltpack devices enable CN to operate locomotives in railyards by remote control, reducing labour costs and the risk of workplace accidents and injuries. With a unit cost of about $200,000 and annual savings of about $300,000 per unit installed, the advantages of Beltpack are obvious. CN has now installed 105 devices to the end of 1996.

CN's supply chain management philosophy has been highly successful, resulting in a total reduction in the cost of materials and services of more than $30 million in 1996. Another $30 million reduction is targeted for 1997. The concept of supply chain management encourages building long-term alliances with suppliers and emphasizes total cost rather than best unit price.

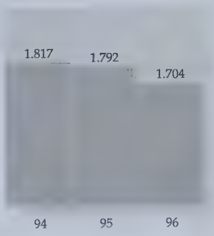
PRODUCTIVITY

Overall productivity increased significantly in 1996. This results from a large number of initiatives across the organization affecting the utilization of our assets, control of our non-labour expenses, and continued downsizing. In addition, CN delivered about 80,000 hours of training to its employees to provide them with the knowledge and skills they need to work safely and efficiently.

The measure of our improvement in productivity can be seen in the reduction of our operating expenses per GTM (excluding special charges), which fell by 5 percent between 1995 and 1996. When inflation is taken into account, including fuel inflation of 13 percent last year, the real improvement in the company's overall productivity was about 7.5 percent.

Improvements in productivity

Cents per GTM



NETWORK RATIONALIZATION

Currently, one-third of CN's lines carry over 85 percent of our traffic. In contrast, the lightest-density third carries only 1 percent of traffic.

CN's strategic goal is to continue to transform itself into a long-haul, high-density railroad. A lower cost structure and less complex operating requirements help shortline operators run their lines at a profit, providing customers with improved service while allowing CN to keep much of the long-haul traffic. This moves CN closer to its goal of operating a higher-density mainline network, fed by cost-efficient shortlines.

As part of that objective, CN continued to meet or exceed the network rationalization goals outlined during its Initial Public Offering. During 1996, 2,400 route miles of track were either eliminated or in the final stages of closure through abandonment or sale to shortline operators. In mid-1996, changes to the Canada Transportation Act provided a simpler, faster process for the sale of non-core lines to shortline operators.

Network rationalization

Route miles rationalized

Total capital expenditures

In millions

Canadian National made significant investments in 1996 to enhance its competitiveness and support long-term revenue growth.

We continued to modernize our fleet with the purchase and delivery of 105 new, high-horsepower SD-75I locomotives. The purchase is part of a long-term replacement program that will generate significant savings in fuel, material, and maintenance costs. In addition to improving service, these new locomotives are expected to reduce operating costs in excess of $15 million per year.

In December, we opened our Gateway Intermodal Terminal just south of Chicago, more than doubling our capacity to handle growing customer demand. The state-of-the-art terminal can store 2,065 containers and 1,100 trailers and handle 225,000 units per year. The terminal can expand to 440,000 units as demand grows.

Gateway Terminal has highly sophisticated loading capabilities with three front-lift mobile cranes, a high-speed overhead crane, and two 7,200-foot loading tracks capable of handling double-stack trains up to 1.3 miles long. Gateway Terminal offers easy access to major U.S. rail networks and to U.S. highways.

The completion of Gateway Terminal, along with our St. Clair tunnel in 1995, the consolidation of our Brampton and Conport intermodal terminals in Ontario, and the addition of an adjacent empty container yard, put CN in an ideal position to take advantage of growth in the intermodal business.

In 1996, we further supported growth in U.S. container traffic with an investment of $2 million in support facilities for the Port of Vancouver's new DeltaPort import-export intermodal terminal.

In addition, CN continued to invest in aluminum coal cars and its heavy axle loading initiative. This allows for longer trains, increased payload per car, reduced unit loading/unloading costs, and an overall increase in productivity of 28 percent.

SERVICE ENHANCEMENT

A major focus in our drive to become the best railroad in North America is to enhance the responsiveness and scope of service we provide. This is critical to supporting profitable top-line growth. In 1996, we made real progress in creating a more customer-focused, more responsive Canadian National.

During 1996, we completed implementation of our Service Reliability Strategy (SRS), giving us the technological platform we need to operate a scheduled railroad. Scheduled railroad operations, which will be phased in during 1997, are based on service goals established by our customers. By matching customer goals against railroad resources, CN will deliver consistent, reliable service while improving the utilization of its assets. The result is proactive management of our customers' shipments, improved communication between CN and its customers, and increased operating efficiencies.

CN is already making significant progress in improved asset utilization. During 1996, locomotive reliability improved about 18 percent over the previous year, and car cycle days were reduced by 7.5 percent, from 24.1 days in 1995 to 22.3 days in 1996.

In October 1996, we opened our new, centralized Customer Support Centre (CSC) in Winnipeg, bringing an immediate improvement in our customer service. The CSC consolidates all CN's previous service centres into one highly efficient facility, giving our customers throughout North America immediate access to expert, knowledgeable support for their transportation needs. The computer system, which routes incoming calls from CN customers to the appropriate CSC customer service representative, also triggers the display of all relevant information for that customer on the representative's terminal screen, including recent shipment status. The customer service representative is then able to use both personal knowledge of the customer's requirements as well as computer-based information to make sure the customer's needs are met. Typical functions handled by CSC employees include order entry, shipment and fleet management, customer support, and processing of waybills.

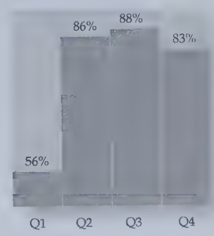
Also located in Winnipeg as part of the CSC is the Account Management Centre (AMC). The AMC integrates CN's marketing and operations functions and acts as a liaison between CSC personnel, CN's growth accounts, and customers in CN's six business groups. Customer priorities are integrated with operating decisions to ensure customer expectations are consistently met. The AMC also provides support for CN business group account managers.

Our focus on customer service through increased capacity and extended reach was exemplified by the completion in July 1996 of the "Superior Connection."

This strategic alliance between CN and Wisconsin Central Railroad, CSX Intermodal, and Illinois Central Railroad provides efficient, seamless intermodal service between western Canada and the eastern and southeastern United States via Chicago. From there, CN customers gain access to CSX's eastern rail network and IC's rail network south to the Gulf of Mexico.

On-time delivery

Average per quarter/ intermodal trains



The Superior Connection means enhanced competitiveness and new business opportunities for CN. It also supports the Port of Vancouver as a viable alternative to the ports of Seattle and Tacoma for overseas shippers routing containers to the eastern United States.

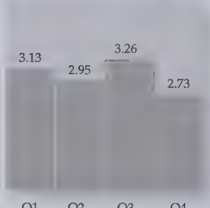
CN continually works to improve on-time performance for customers. A comprehensive approach in the intermodal area helped us improve on-time performance of our intermodal trains to best-ever levels in 1996. On-time performance averaged 78 percent at the end of 1996, an improvement of 10 points over 1995. Our Halifax to Chicago corridor achieved 87 percent on-time performance in 1996.

We also developed a Winter Operations Plan to improve service and safety during the winter months. Our Winter Plan focuses on meeting customer service needs during winter weather conditions. The plan combines additional equipment – new Snow Jets, hot box detectors, and wheel impact load detectors – with proactive storm management techniques. The plan has proven highly effective in helping CN return to normal operations quickly after severe winter conditions.

SAFETY

Number of train accidents

FRA reportable: per million train miles



Average for 1996: 3.0

1996 was the year we revitalized our safety programs and practices. While we held steady as the third-safest railroad in North America, our goal is to become the safest. During 1996, we implemented an aggressive, 14-point safety plan that addresses every aspect of our operations. The plan is characterized by proactive communication at all levels of the organization, zero tolerance of noncompliance, and performance-based awards.

The plan ensures that our policies and practices continue to be effective in promoting the safe operation of our trains and the safety of our employees.

All CN track and equipment is maintained to standards that meet or exceed federal regulatory requirements. In addition to federally mandated certified inspections, railcars undergo frequent visual inspections by operating personnel. Track is inspected both visually and electronically on a regular basis – more frequently during extreme weather conditions and in high-density corridors.

We use high-tech monitoring and detection devices at every major strategic and high-density location across the system for maximum assurance of safety. For example, CN's wheel impact load detector network is the most extensive in North America, comprising 11 sites linked directly to repair points and monitored on a 24-hour basis. As well, CN's aggressive winter operating plan is designed to improve safety performance.

We have a number of annual award programs in place to encourage and reward excellence in safety performance, including system safety awards, the Board of Directors Award, and the President's Awards. In 1997, we will implement a new safety award program that shares money saved through improved safety performance with eligible groups of operating employees.

Also in 1996, we broke new ground when we appointed the railroad industry's first safety ombudsman. The CN safety ombudsman is dedicated to excellence in safety performance, reporting directly to CN's president and chief executive officer. Supported by a 1-800 safety hotline, the safety ombudsman provides employees with an additional recourse for the resolution of safety concerns.

THE ENVIRONMENT

Canadian National has taken a proactive approach in establishing itself as an environmentally responsible railroad that effectively balances the objectives of its business plan and sound environmental policy. Over the next three years, CN plans to spend $130 million in enhanced environmental property management: $87 million of this amount has been accrued for site remediation and containment projects, and an additional $43 million of capital expenditures will be used for a range of environmental initiatives, including improved fuel management practices and waste water treatment.

We see these expenditures as an integral part of running a first-class freight railroad. Communities, employees, and customers alike expect CN to do its part to protect the environment. For example, the modernization of all CN's fueling facilities will improve CN's ability to protect the environment. Hundreds of underground fuel storage tanks are being removed and replaced with state-of-the-art, above-ground storage tanks. In addition, employees are being trained in environmentally friendly fuel management procedures.

CN is also upgrading the locomotive wash facilities and waste water treatment plants at many of its facilities and installing newer technologies that reduce the consumption of both water and chemicals. Many other initiatives are now under way to upgrade CN's equipment, and technology will also have a positive impact on the environment.

"I know the pressures that CN employees work under, and I believe you can't thank employees often enough for their excellent work and dedication. These awards recognize employee excellence, creativity, and initiative."
–Paul M. Tellier

Category 1: *New business opportunities*

The CN-Noranda team, from Noranda, Quebec: Denis Babin, Larry Urbanoski, Gerry Bisaillon, and John Murphy. From CN: Mary Taylor, Moncton, New Brunswick; Levi LeBlanc, Moncton, New Brunswick; Clarence Robichaud, Notre Dame, New Brunswick; Jean-Guy Gagnon, Moncton, New Brunswick; Pierre Dubé, Montreal, Quebec; and Manning Jay, Moncton, New Brunswick

Developed a quick, effective way to unload sticky ore concentrates from railcars. Kept business from switching to trucks and opened the door to new business opportunities.

Special contribution

Alain Thauvette, Toronto, Ontario

Turned new intermodal technology–Ecorail–into a viable service.

Category 2: *Safety*

William English, Winnipeg, Manitoba

Made a safety video to remind employees that safety is not a choice, it's a necessity. Other North American railroads now use the video in training programs.

Gary A. Carlson, Kenneth Earl Haugen, and Charles Wollack, Superior, Wisconsin

Actively promoted safety on the Duluth, Winnipeg & Pacific Railroad (a wholly owned CN subsidiary) and pioneered a wellness program and annual healthy lifestyle fair.

Category 3: *Exceptional service*

André Gravel, Senneterre, Quebec; Réjean Gravel, Senneterre, Quebec; Yvon Généreux, Fitzpatrick, Quebec; Alain Michaud, St. Georges de Champlain, Quebec; Richard Beaudoin, Senneterre, Quebec; Louis Villemure, Parent, Quebec; and Robert Thiffault, Parent, Quebec

Protected their subdivision during unusually severe forest fires in northern Quebec. The subdivision extended over 21 miles and included six bridges.

Category 4: *Operational breakthrough*

Gary Monaghan, Toronto, Ontario

Developed a successful action plan that allowed CN to continue regular track maintenance during a season of extreme fire hazard warnings.

Category 5: *People management*

Serge Sirois, Charny, Quebec

Recognized for his exceptional team leadership skills and proactive, take-charge attitude.

Category 6: *Cost effectiveness*

George Pearson, Detroit, Michigan

Found a way to close a level crossing that saved CN money, improved traffic flow, and gave townspeople better access to an adjacent park.

Category 7: *Quality improvement*

Traction motor process improvement team: Moe Gendreau, Lorrie Lewsey, Gord Pachal, Dave Paulusma, Lou Tarnoky, Ralph Booker, Jim Kuziw, Ross Aitkenhead, Darryl Barker, Peter McCarthy, Gary Foster, and Larry Wishlow, all of Winnipeg, Manitoba

Improved the work flow at CN's Transcona traction motor repair facility and doubled the facility's productivity.

Category 8: *Environmental impact*

Calvin Enokson, Edmonton, Alberta

Created an environmental policy and procedures manual that has since become the "bible" for all CN employees at the Walker Yard locomotive reliability centre. The result is a cleaner, safer, more efficient shop operation.

Contents

Canadian National Railway Company

The CN pension plan and the CN 1935 pension plan

Management's discussion and analysis relates to the financial condition and results of operations of Canadian National Railway Company (CN). CN and its wholly owned U.S. subsidiary, Grand Trunk Corporation, operate a private-sector freight railroad. CN's common shares are listed on the Toronto, New York, and Montreal stock exchanges. All financial information reflected herein is expressed in Canadian dollars and determined on the basis of Canadian generally accepted accounting principles ("GAAP"), which conform, in all material respects, with those generally accepted in the United States except as discussed in Note 19 to the Consolidated Financial Statements.

Financial results

Overview: 1996 – A Year of Achievements

During this first full year as a private-sector railroad, CN achieved the major performance objectives set by its management team and ended the year with an operating ratio (excluding special charges) for 1996 of 85.3%. This ratio surpassed the targeted ratio of 85.6% and represented a 4 percentage point improvement over the preceding year. Several factors combined to produce a $526 million increase in cash from continuing operations, thereby strengthening the Company's capital structure by reducing the debt ratio to 37.4% from its 1995 level of 39.1%. In addition, the Company paid dividends of $68 million or 80 cents per share on its common shares. As a result of the Company's outstanding performance and continued strong prospects, the board of directors approved a 15% increase in its 1997 first quarter dividend to 23 cents per share.

Much of the financial improvement achieved was due to stringent control over operating expenses and the Company's workforce reduction program. In 1996, the Company reached its initial workforce downsizing target by achieving a workforce reduction of over 11,000 employees. In the fourth quarter of 1996, consistent with its previously communicated goals to further improve productivity through workforce reductions, the Company committed to specific workforce reduction plans. These plans include a total of 2,250 employee reductions which began in the fourth quarter of 1996 and are to be completed by the end of 1997. In connection with these plans, the Company recorded a special charge of $365 million in the fourth quarter of 1996.

Milestones now achieved in the Company's turnaround strategy include the aforementioned workforce reductions and strengthened capital structure as well as operational enhancements through more flexible labour agreements, continuing plant rationalization through abandonment of low-density branch lines or their sale to shortline railroads, accelerated modernization of the locomotive and railcar fleets, and the implementation of systems to enhance the reliability of service to customers. These achievements have left the Company with a more competitive cost structure and will now permit it to turn its emphasis to the next key phase of its turnaround strategy, which will be increasingly anchored on achieving profitable revenue growth.

1996 compared to 1995

The Company recorded a consolidated net income of $142 million ($1.67 per share) in the year ended December 31, 1996, compared with a consolidated net loss of $1,085 million ($13.49 per share) in 1995. Included in the consolidated net income for 1996 and consolidated net loss for 1995 are special charges of $381 million and $1,453 million, respectively, described below. Excluding the special charges, net income for 1996 would have been $523 million ($6.16 per share) compared to $368 million ($4.57 per share) in 1995.

Including special charges, rail operations recorded operating income of $229 million in the year ended December 31, 1996 compared with an operating loss of $1,013 million in 1995. Excluding special charges, rail operations produced operating income of $610 million in 1996, an increase of $170 million or 39%

from 1995. There was a $61 million gain in revenues and a $109 million reduction in operating expenses (excluding special charges). The improved financial performance was primarily the result of the Company's ongoing implementation of its cost reduction strategy. The operating ratio (excluding special charges) decreased from 89.3% to 85.3% as a result.

Revenues

Revenues for the year ended December 31, 1996 totalled $4,159 million, an increase of $61 million or 1.5% from the comparable 1995 level. Revenue ton miles increased by 2%. The increased volume was attributable mainly to a 14% increase in intermodal traffic and a 6% increase in industrial products.

Year ended December 31	1996	1995	1996	1995	1996	1995
	Revenues		Revenue ton miles		Freight revenues per revenue ton mile	
	In millions				*In cents*	
Industrial products	$ 866	$ 848	22,551	21,328	3.84	3.98
Forest products	790	774	21,297	21,278	3.71	3.64
Grain and grain products	570	603	20,755	22,861	2.75	2.64
Coal, sulphur and fertilizers	622	603	23,730	23,012	2.62	2.62
Intermodal	710	669	16,507	14,537	4.30	4.60
Automotive	402	412	2,630	2,471	15.29	16.67
Other items(1)	199	189	–	–	–	–
Total	$4,159	$4,098	107,470	105,487	3.68	3.71

(1) Principally revenues derived from use of road by third parties providing passenger rail services.

Industrial products: Revenues increased by 2% and volumes increased by 6% over 1995. Petroleum products led the way, with increased demand for liquefied petroleum gas, strong performance in fuel oils due to cold weather early in the year, and the Ultratrain operation (a very high-volume short-haul unit train for petroleum products) which began in August. Gains were also registered in plastics and industrial chemicals, which were fueled by solid market demand and improved market share in specific chemical markets. The decline in yield resulted from traffic mix changes and the effect of the Ultratrain.

Forest products: Revenues increased by 2% over 1995 while volumes remained basically flat. Growth in lumber and panel traffic was driven by stronger housing markets in Canada and the United States, as well as the start-up or expansion of six oriented strand board mills on CN lines. These gains were offset by a decrease in the fibre segment, caused primarily by low demand for woodchips due to plant shutdowns in the pulp and paper sector. Newsprint was also down in 1996, in line with weak market demand in the United States. Changes in traffic mix and pricing structure are responsible for the 2% increase in yield.

Grain and grain products: Revenues decreased by 5% from 1995 while volumes dropped by 9%. During the first two quarters of 1996, grain shipments had been negatively impacted by a lower supply of grain in CN territory, severe winter conditions, and slow producer deliveries. This weakness was reversed late in the third quarter due to a large western crop and culminated in a strong fourth quarter gain. Revenues per revenue ton mile increased 4%, primarily due to a rate increase of 7% in August 1996 on regulated export grain, which accounts for about two-thirds of grain

tonnage transported. CN is continuing to encourage new or upgraded long-term elevators and processing facilities on its lines. In 1996, CN customers announced the construction of 11 new high-through-put elevators. In addition, the largest canola crushing facility in Canada opened on CN lines in June 1996.

Coal, sulphur, and fertilizers: Revenues and volumes increased by 3% over 1995, led by increased fertilizer movements to U.S. markets; new potash traffic, in spite of an overall decline in Canadian potash exports; and increased share of the Canadian domestic coal market. These gains were partly offset by drops in sulphur exports to the United States and in export coal, due to production problems at three mines.

Intermodal: Volumes increased by 14%, and revenues increased by $41 million. All segments were up, led by overseas with an 18% increase in revenues. This growth was driven by strong Canadian trade and significant increases in traffic between Halifax and Chicago and from Vancouver to Central Canada. Domestic growth was driven by overall economic conditions and especially by increased use of CN's improved intermodal service by retail customers and truckers across Canada. Rerouting of transcontinental traffic away from the Ottawa Valley route for operational efficiency reasons caused an increase in the average length of haul. Also contributing to the decreased yield was a change in mix and a shift of business from retail to wholesale.

Automotive: Revenues for the year were down 2%, while volumes were up 6%. The volume growth reflects improving motor vehicle markets in the United States and Canada and an increase in the average length of haul. This growth was achieved in spite of the Canadian Auto Workers (CAW) strike at GM, which lasted 21 days in October, mostly impacting finished vehicle traffic from the Oshawa plants, and the UAW strike, which lasted 17 days in March, affecting parts traffic and finished vehicle movements from Oshawa, Lansing, and Pontiac. The drop in revenues per revenue ton mile is attributable to the increase in the average length of haul and a change in mix.

Operating expenses

Total operating expenses including special charges amounted to $3,930 million in 1996 as compared to $5,111 million in 1995. Excluding special charges of $381 million in 1996 and $1,453 million in 1995, operating expenses decreased by $109 million or 3% from the 1995 period while traffic levels increased by 2%.

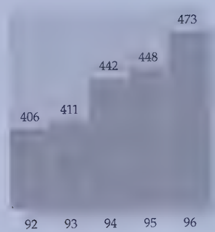
Dollars in millions — *Year ended December 31*	1996		1995	
	Amount	% of revenue	Amount	% of revenue
Labour and fringe benefits	$1,407	33.8%	$1,502	36.7%
Material	304	7.3%	324	7.9%
Fuel	314	7.6%	277	6.8%
Depreciation and amortization	194	4.7%	231	5.6%
Operating taxes	171	4.1%	192	4.7%
Equipment rental	216	5.2%	194	4.7%
Net car hire	108	2.6%	117	2.9%
Purchased services	450	10.8%	444	10.8%
Casualty and insurance	85	2.0%	52	1.3%
Other	300	7.2%	325	7.9%
	3,549	85.3%	3,658	89.3%
Special charges	381		1,453	
Total operating expenses	$3,930		$5,111	

Industrial products

Percentage of revenues

Carloads

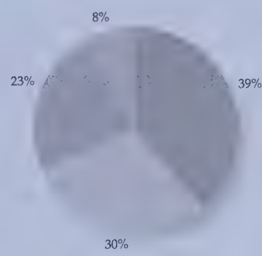
In thousands



31% Chemicals
31% Petroleum products
38% Metals and construction materials

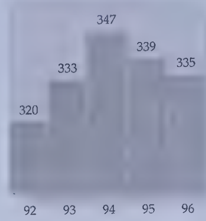
Forest products

Percentage of revenues



Carloads

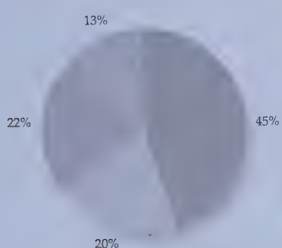
In thousands



39% Lumber
30% Fibres
23% Paper
8% Panels

Grain and grain products

Percentage of revenues



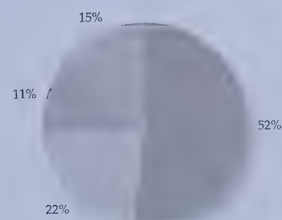
Carloads

In thousands

45% Wheat
20% Oilseeds
22% Feed grains
13% Other grains

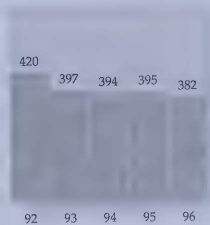
Coal, sulphur, and fertilizers

Percentage of revenues



Carloads

In thousands



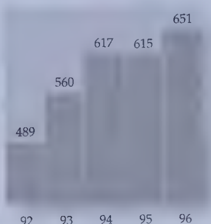
52% Coal
22% Potash
11% Sulphur
15% Fertilizers

Intermodal

Percentage of revenues

Carloads

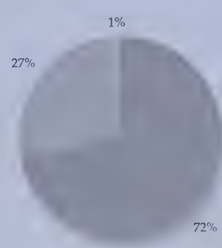
In thousands



68% Domestic
32% Overseas

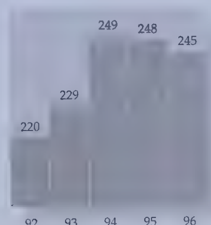
Automotive

Percentage of revenues



Carloads

In thousands



72% Finished vehicles
27% Vehicle parts
1% Agricultural imports and miscellaneous

Labour and fringe benefits: These costs decreased by $95 million or 6%, as the Company experienced significant labour savings from its workforce reduction program. Average employment declined by 11% from 1995. A decrease in pension expense, as a result of improvement in the return on the Company's pension plan assets, also contributed to lower labour and fringe benefit costs. These reductions were partly offset by increased wage rates under collective labour agreements. As measured by revenue ton miles per employee, the Company's overall productivity improved by 14% to 4.47 million, resulting in the nearly 3 point drop in labour and fringe benefit costs expressed as a percentage of revenues.

Material: Costs of material consumed during 1996 were 6% lower than in 1995. The decrease was achieved as a result of reduced shopwork combined with improved equipment maintenance procedures and more efficient purchasing practices.

Fuel: Increases of 12% in fuel prices and 2% in traffic volumes, partly offset through improved efficiency, caused an increase in fuel expense of $37 million or 13% compared to 1995.

Depreciation and amortization: This expense decreased by $37 million or 16%. The reduced asset base resulting from the $1,300 million write-down of rail operating assets in the east in June 1995 reduced depreciation by $60 million for the full year compared to $30 million in 1995. The sale and leaseback of the Company's vehicle fleet in the fourth quarter of 1995 was a further factor in the decrease.

Operating taxes: Reductions in provincial sales taxes and municipal taxes due to exemptions from certain school taxes on bridges and right of way, combined with a refund of sales taxes relating to rolling stock, resulted in a $21 million or 11% decrease in operating taxes compared with 1995.

Equipment rental: Such costs increased by $22 million or 11% compared with 1995. Higher rentals due to the sale and leaseback of the Company's vehicle fleet were partly offset by reduced rentals for covered hopper cars leased for grain service.

Net car hire: Car hire costs decreased by $9 million or 8% from the 1995 level. The decrease was attributable mainly to fewer foreign cars on-line, fewer short-term operating leases, and the Company's efforts to improve car cycles.

Purchased services: Costs of purchased services increased by $6 million or 1% from the 1995 level, due mainly to increased expenditures for outsourcing and professional services, switching services, and contracted repairs.

Casualty and insurance: Costs increased by $33 million or 63% due to increased provisions for legal claims and train accidents and increased costs for personal injury claims, partly offset by a $12 million recovery of insurance premiums associated with the liquidation of the Company's interest in an industry insurance association.

Special charges: Special charges of $381 million in 1996 included $365 million related to workforce reductions, while $16 million related to the Company's debt reduction program. The downsizing charge relates to a total of 2,250 reductions which began in the fourth quarter of 1996 and are to be completed by the end of 1997. Special charges of $1,453 million in 1995 included $1,300 million with respect to an asset impairment write-down of certain of the Company's railway assets.

Other

Interest: Interest expense was $114 million in 1996 compared to $198 million in 1995, a reduction of $84 million or 42%. This was a result of the repayment and defeasance of $1,046 million of long-term debt undertaken at the time of the Company's privatization.

Other income: Other income for the year ended December 31, 1996 was $20 million compared to $100 million in 1995. The reduction was due primarily to income in 1995 having included a gain of $39 million on the sale of the operating assets of Central Vermont Railway to a shortline operator and gains on sale of surplus rail properties.

Income tax (expense) recovery from continuing operations: Income tax expense was $11 million in 1996 compared to a recovery of $19 million the preceding year. In 1995, the recovery resulted mainly from utilization of the Company's available tax benefits to offset the tax expense arising from the gain on sale of discontinued operations and from the capital reorganization.

Discontinued operations: During 1996, the Company sold its non-rail subsidiary CN France S.A. The financial effects of the disposal and operations of this formerly owned business are included in Discontinued operations. Discontinued operations (net of applicable income taxes) provided income of $18 million compared to income of $7 million in 1995, due primarily to the gain of $14 million on the sale of CN France S.A.

1995 compared to 1994

The Company recorded a consolidated net loss of $1,085 million ($13.49 per share) in the year ended December 31, 1995 compared with consolidated net income of $245 million ($3.06 per share) in 1994. This loss was attributable to special charges totalling $1,453 million in rail operations which are described below. Excluding the special charges, net income for 1995 would have been $368 million ($4.57 per share) compared to net income of $245 million ($3.06 per share) in 1994. Offsetting the effect of the special charges, to some extent, was "Other income" of $100 million (including a gain on disposal of the operating assets of the Company's subsidiary Central Vermont Railway of $39 million, gains on property disposals of $44 million, and investment and rental income of $19 million). Income from discontinued operations of $7 million consists primarily of the gains on disposal of properties of the former CN Real Estate division and of the oil and gas assets of CN Exploration, offset by a provision for the disposal of AMF, all net of applicable income taxes.

Including special charges, rail operations recorded an operating loss of $1,013 million in the year ended December 31, 1995 compared with operating income of $457 million in 1994. Excluding special charges of $1,453 million, rail operations produced operating income of $440 million in 1995, a decrease of $17 million or 4% from 1994. The reduction in revenues of $207 million was largely offset by the reduction in operating expenses of $190 million (excluding special charges). The operating ratio decreased from 89.4% to 89.3% (excluding special charges), as the decline in expenses was proportionately greater than the decline in revenues. The reduction in operating income can also be partly attributed to a work stoppage in March 1995 which effectively stopped the Company's rail operations for nine days. The loss of revenues during the strike was offset to some extent by reduced expenses. In addition, the Company believes that a substantial portion of the lost revenues was recovered by the end of June as a result of later shipments of goods.

Revenues

Revenues for the year ended December 31, 1995 totalled $4,098 million, a decrease of $207 million or 5% from the comparable 1994 level. Revenue ton miles decreased by 3%. A major part of the decline was attributable to reduced revenues from grain and grain products, following an exceptionally strong year for the export of Canadian grain in 1994. Extreme weather conditions in the fourth quarter of 1995 were also a factor.

Year ended December 31	1995	1994	1995	1994	1995	1994
	Revenues		Revenue ton miles		Freight revenues per revenue ton mile	
	In millions				*In cents*	
Industrial products	$ 848	$ 830	21,328	20,376	3.98	4.07
Forest products	774	790	21,278	21,652	3.64	3.65
Grain and grain products	603	788	22,861	28,239	2.64	2.79
Coal, sulphur and fertilizers	603	566	23,012	21,239	2.62	2.66
Intermodal	669	718	14,537	14,952	4.60	4.80
Automotive	412	406	2,471	2,546	16.67	15.95
Other items[1]	189	207	–	–	–	–
Total	$4,098	$4,305	105,487	109,004	3.71	3.76

(1) Principally revenues derived from use of road by third parties providing passenger rail services.

Industrial products: Revenues improved by 2% through continued traffic growth in several areas, including nonferrous ores and metals, petroleum products, construction materials, and plastics and other chemical products. Strong increases in volumes of liquefied petroleum gas reflected the strengthening competitive position of western Canadian-originated product in the North American market.

Forest products: Revenues declined by 2% due to depressed lumber and panel markets, which were adversely affected by lower housing starts throughout North America. Newsprint traffic levels also reflected a softer domestic economy. These trends were mitigated by continuing strength in woodpulp markets. The Company serves two of the main forest fibre producing regions of North America, eastern Canada and British Columbia/Alberta, and thus participates in both domestic and export markets for forest products.

Grain and grain products: Revenues declined by 23% as compared to 1994, when CN experienced an exceptional year due to a major increase in Canadian grain exports. The decline in 1995 also reflects a 7% reduction in rates on movements of regulated grain which came into effect in August 1994 and reduced carloadings, particularly during the summer months of 1995, stemming from reduced inventory levels in the grain delivery system. Effective August 1, 1995, Government of Canada payments to the railroads under the Western Grain Transportation Act ceased, and grain transportation costs became the responsibility solely of the shippers. As part of an ongoing program to upgrade its grain handling network, the Company attracted more than fifteen new processing facilities and high-through-put elevators to its lines during 1995.

Coal, sulphur, and fertilizers: Revenues increased by 7% due particularly to improving international sulphur market conditions and a strong increase in fertilizer traffic (excluding potash). Coal revenues were up, reflecting continued strength in export markets. In addition, CN coal customers renewed key contracts with Japanese and Korean coal importers. The Company's principal focus in the coal, sulphur, and fertilizer market is to improve the efficiency of its operations through such cost-reduction initiatives as increasing payloads and acquiring new high-productivity aluminum railcars for the movement of coal.

Intermodal: Revenues were down by 7% due to the combination of softening domestic markets and loss of certain traffic caused by the Company's work stoppage in March. Strong growth continued in overseas traffic, both import and export. Import container traffic originating in Halifax increased sharply, partly as a result of the improved transit times available through CN's new St. Clair Tunnel. Also, larger container ships are calling at Halifax and offloading containers for the Midwest, thereby meeting limited draught requirements for their subsequent calls at New York.

Automotive: Revenues improved by 1% during the year ended December 31, 1995, in spite of a weakening in motor vehicle sales both in Canada and the United States. Factors contributing to this trend include the popularity of certain vehicle models built at Company-served facilities and the competitiveness of Canadian vehicle manufacturing plants, as well as the impact in the early part of the year of the depreciating Canadian dollar on the business unit's revenues, which are primarily denominated in U.S. dollars.

Operating expenses

Total operating expenses including special charges of $1,453 million amounted to $5,111 million in 1995 as compared to $3,848 million in 1994. Excluding special charges, operating expenses decreased by $190 million or 5% from the 1994 period while traffic levels decreased by 3%.

Dollars in millions — *Year ended December 31*	1995		1994	
	Amount	% of revenue	Amount	% of revenue
Labour and fringe benefits	$1,502	36.7%	$1,646	38.2%
Material	324	7.9%	389	9.0%
Fuel	277	6.8%	276	6.4%
Depreciation and amortization	231	5.6%	256	6.0%
Operating taxes	192	4.7%	192	4.5%
Equipment rental	194	4.7%	180	4.2%
Net car hire	117	2.9%	96	2.2%
Purchased services	444	10.8%	445	10.3%
Casualty and insurance	52	1.3%	82	1.9%
Other	325	7.9%	286	6.7%
	3,658	89.3%	3,848	89.4%
Special charges	1,453		–	
Total operating expenses	$5,111		$3,848	

Labour and fringe benefits: These costs decreased by $144 million or 9%, reflecting benefits of the Company's continuing downsizing efforts as average employment declined by 10% from 1994. Shortly after year end, the Company completed its three-year program for eliminating 11,000 employees from the workforce.

Material: Costs of material consumed were 17% lower in the 1995 period as a result of improved equipment maintenance procedures, more efficient purchasing practices (including consolidation of the Company's supplier base and signing of long-term contracts), and lower equipment maintenance requirements.

Fuel: Fuel expenses remained flat as decreased traffic volumes and fuel efficiencies offset the impact of a 5% increase in the average price paid for fuel in Canada in 1995 as compared with the average price for 1994.

Depreciation and amortization: This expense decreased by $25 million or 10%. The reduced asset base resulting from the second quarter $1,300 million write-down of rail operating assets in the east brought about a $30 million reduction in depreciation, offset in part by an increase in certain depreciation rates.

Equipment rental: Such costs increased by $14 million or 8% in 1995 as the Company leased a larger proportion of freight cars.

Net car hire: Car hire costs increased by $21 million or 22% due to increased per diem payments to other railroads for their freight cars while on CN lines.

Purchased services: Costs of purchased services remained relatively unchanged from those in 1994.

Casualty and insurance: Costs decreased by $30 million or 37% due to an actuarial reduction in provisions for injuries to persons, recoverable amounts from third parties, and a substantial reduction in lost-time injuries.

Special charges: Special charges of $1,453 million included $1,300 million with respect to an asset impairment write-down of certain of the Company's railroad assets taken as a result of an analysis of its eastern rail operations, which have been affected by continued excess capacity and intense competition in the transportation industry leading to significant losses from these operations; $88 million for estimated costs to comply with environmental laws and to contain migration of contamination or, at selected sites, to remediate historical contamination taken as a result of a recent review of potential environmental costs and liabilities; $38 million in debt repayment and defeasance costs relating to the Company's financial restructuring in conjunction with its privatization; $14 million for inventory write-downs related to inventory determined to be inactive, obsolete, or surplus resulting in an adjustment to carrying values to reflect estimated realizable values; and $13 million as a provision for certain legal claims.

Other

Interest: Interest expense remained relatively flat at $198 million in 1995 compared to $196 million in 1994. As a result of the restructuring of the Company and repayment and defeasance of long-term debt, future annual interest expense will be reduced by approximately $100 million.

Other income: Other income for the year ended December 31, 1995 increased by $73 million due primarily to a gain of $39 million on the sale of the operating assets of Central Vermont Railway to a shortline operator and gains on sale of surplus rail properties.

Income tax (expense) recovery from continuing operations: There was an income tax recovery of $19 million in 1995 compared to expense of $24 million the preceding year. This recovery resulted mainly from the utilization of the Company's available tax benefits to offset the tax expense arising from the gain on sale of discontinued operations and from the capital reorganization.

Discontinued operations: Discontinued operations (net of applicable income taxes) provided income of $7 million compared to a loss of $19 million in 1994, due primarily to gains on sale of properties of the former CN Real Estate division and of the oil and gas assets of CN Exploration. To a large extent, these gains were offset by a provision of $80 million less a related income tax recovery of $33 million for costs to dispose of AMF. The sale of AMF was completed in the first quarter of 1996.

Liquidity and capital resources

Operating activities: Cash provided from continuing operations, which is the Company's principal source of liquidity, was $552 million for the year ended December 31, 1996, up $526 million from the preceding year. The improvement from 1995 was a result of increased income from continuing operations, an improved billing and collection cycle for receivables, and favourable activity in accounts payable.

Cash payments with respect to workforce reductions amounted to $307 million for the year ended December 31, 1996. The Company regards these payments for workforce reduction as an investment which results in lower labour costs. The Company expects to benefit from further savings in future years. As a result of these payments and the special charge of $365 million recorded in the fourth quarter of 1996, the workforce reduction provisions have been increased to $655 million as at December 31, 1996. The Company believes that these provisions are adequate for future cash payments required for the workforce reduction plans that are completed or underway at the end of 1996.

Cash payments in respect of income taxes and the Canadian Federal Large Corporations Tax amounted to $11 million for the year ended December 31, 1996. As at December 31, 1996, the Company had accumulated timing differences of approximately $1,700 million available to reduce taxable income of future years, which amount is comprised of accumulated net loss carryforwards for Canadian federal tax purposes of about $600 million from claiming maximum capital cost allowance for tax purposes in excess of reported depreciation and amortization expense, with the remainder representing expenses recorded in the financial statements not yet claimed for income tax purposes. The Company therefore does not expect to be required to make any significant cash payments for Canadian federal income taxes prior to 1999.

Investing activities: Capital expenditures for rail operations amounted to $496 million in the year ended December 31, 1996, an increase of 52% over 1995, primarily due to the acquisition of 105 new locomotives. Other capital expenditures included roadway renewal, rolling stock and intermodal equipment additions, and other capacity and productivity improvements. The Company anticipates that capital expenditures net of salvage proceeds for 1997 through 1999 will aggregate approximately $1,400 million and be approximately equal in each of the three years. This will include funds required for ongoing renewal of the basic plant, the locomotive upgrade program, railcar acquisitions for targeted market opportunities, and other acquisitions and investments required to improve the Company's operating efficiency and customer service. Included in such expenditures is approximately $125 million for the planned acquisition of new locomotives.

The Company expects that it will be able to fund all or substantially all of its capital expenditures through 1999 with cash generated from operations (other than equipment financing and borrowings for short-term working capital needs in the ordinary course of business). As at December 31, 1996, the Company had commitments to acquire locomotives and freight cars at a cost of $138 million, rail at a cost of $26 million, and railway ties at a cost of $20 million.

Financing activities: Cash used for the reduction of long-term debt, consisting primarily of completion of the debt redemption program commenced in 1995, amounted to $294 million. New debt issues, principally in capital leases, totalling $213 million were mainly for the acquisition of locomotives under the locomotive upgrade program. The Company has no significant long-term indebtedness maturing prior to May 1999. Any short-term working capital deficiency is expected to be financed under committed revolving credit facilities. The Company has entered into credit agreements providing for committed revolving credit facilities of Cdn $300 million and U.S. $150 million for a two-year term arranged through a syndicate of financial institutions. The facilities provide for various types of loans at varying rates based on certain benchmark rates, including Canadian Prime Rate, the U.S. Base Rate, the U.S. Federal Funds Effective Rate, and the London Inter Bank Offer Rate, and on the Company's credit rating at the time of drawdown. For the year ended December 31, 1996, the Company has not drawn down on the credit facilities.

Environmental and other risks

Environment

The Company's operations are subject to extensive federal, provincial, state, municipal, and local regulation under environmental laws and regulations concerning, among other things, emissions into the air, discharges into waters, the generation, handling, storage, transportation, treatment, and disposal of waste, hazardous substances, and other materials, decommissioning of underground and above-ground storage tanks, and soil and groundwater contamination. A risk of environmental liability is inherent in the railroad and related transportation operations, real estate ownership, operation or control and other commercial activities of the Company with respect to both current and past operations. As a result, the Company will incur significant compliance and capital costs, on an ongoing basis, associated with environmental regulatory compliance and clean-up requirements in its railway operations and relating to its past and present ownership, operation, or control of real property.

While the Company believes that it has identified the costs likely to be incurred in the next several years for environmental matters, the Company's ongoing efforts to identify potential environmental concerns that may be associated with its properties may lead to future environmental investigations, which may result in the identification of additional environmental costs and liabilities.

As at December 31, 1996, the Company had aggregate accruals for environmental costs of $87 million. The Company has not recorded any reduction in costs for anticipated recovery from insurance. Eleven million was charged to the provision for environmental costs in 1996, $9 million in 1995, and nil in 1994. Related environmental capital expenditures were $13 million for 1996, $5 million in 1995, and $5 million in 1994. In addition, the Company expects to incur capital expenditures related to environmental matters of approximately $16 million in each of 1997 and 1998 and $11 million in 1999.

Legal actions

In the normal course of its operations, the Company becomes involved in various legal actions, including claims relating to injuries and damage to property. The Company maintains provisions for such items which it considers to be adequate. While the final outcome with respect to actions outstanding or pending as at December 31, 1996 cannot be predicted with certainty, it is the opinion of management that their resolution will not have a material adverse effect on the Company's financial position.

Business risks

In any given year CN, like other railroads, is susceptible to changes in the economic conditions of the industries and geographic areas that produce and consume

the freight it transports. Many of the goods and commodities carried by the Company experience cyclicality in demand. However, many of the bulk commodities CN transports move offshore and are impacted more by global economic conditions than North American economic cycles. The Company's results of operations can be expected to reflect this cyclicality because of the significant fixed costs inherent in railroad operations. The Company's revenues are affected by prevailing economic conditions, and should an economic slowdown or recession occur in North America or other key markets, the volume of rail shipments carried by the Company is likely to be reduced.

In addition to the inherent risks of the business cycle, the Company is occasionally susceptible to severe weather conditions. For example, in early 1996, northern Ontario recorded nearly three times the average snow fall, and western Canada was hit with record-breaking cold temperatures. Similarly, in late 1996, CN's operations in British Columbia were impacted by severe snowfalls which caused blockages on the main line serving Vancouver and temporarily halted train operations.

Generally accepted accounting principles require the use of historical cost as the basis of reporting in financial statements. As a result, the cumulative effect of inflation, which has significantly increased asset replacement costs for capital-intensive companies such as CN, is not reflected in operating expenses. Depreciation charges on an inflation-adjusted basis, assuming that all operating assets are replaced at current price levels, would be substantially greater than historically reported amounts.

Effects of currency exchange

Although the Company conducts its business and receives revenues primarily in Canadian dollars, a portion of its business is conducted and revenues are denominated in U.S. dollars. Thus, the Company's results are affected by fluctuations in the exchange rate between these currencies. However, the conversion impact on revenues and expenses is largely offsetting. Nevertheless, changes in the exchange rate between the Canadian dollar and other currencies (including the U.S. dollar) make the goods transported by the Company more or less competitive in the world marketplace and thereby can affect the Company's revenues.

The Company has limited involvement with derivative financial instruments and does not use them for trading purposes. The Company has entered into forward exchange contracts (currency swaps) with respect to certain obligations denominated in currencies other than Canadian or U.S. dollars in connection with existing indebtedness. These forward exchange contracts act as a hedge to effectively fix the amount of Canadian dollars required over the term of the debt to make all necessary payments in the foreign currency of issue. The Company has not incurred net gains or losses in respect of these transactions.

The Company has developed a program to protect its operating margins and overall profitability from adverse fuel price changes. The program will use swaps, futures, and forward contracts to mitigate the risk of fuel price volatility.

Accounting principles

All financial information reflected herein is expressed in Canadian dollars and determined on the basis of Canadian generally accepted accounting principles, which conform, in all material respects, with those generally accepted in the United States except as discussed in Note 19 to the Consolidated Financial Statements. The major differences affecting net income are the accounting for income taxes, the accounting for stock-based compensation, and the treatment of unrealized foreign currency exchange gains and losses on long-term monetary items. In addition, there are certain industry practices that differ in the areas of revenue recognition and methods of capitalization, which the Company will be addressing in 1997.

The Company follows the deferral method of accounting for income taxes in accordance with

Canadian GAAP, which relates the provision for income taxes to the accounting income for the period. Under the deferral method, the amount by which the tax provision differs from the amount of taxes currently payable is considered to represent the deferring to future periods of benefits obtained or expenditures incurred in the current period and accordingly is computed at current tax rates. The accumulated tax allocation debit or credit balance is not adjusted to reflect subsequent changes in tax rates.

In the United States, Financial Accounting Standards 109 (FAS 109) requires the use of the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred income taxes are recognized for the future tax consequences attributable to differences between the financial statement carrying values and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

Under FAS 109, the effect on deferred tax assets and liabilities of a change in tax rates is included in income in the period that includes the enactment date. The Company has analyzed the sources and expected reversal periods of its deferred tax assets and liabilities and has evaluated all relevant factors. The Company believes that the continuation of certain positive trends, including net income (excluding special charges) for the current year and the previous two years, will result in the utilization of the tax loss carryforwards over a shorter period of time than had been projected in previous years. Additionally, the Company believes that the tax benefits attributable to deductible temporary differences also will be realized as a result of future taxable income. Accordingly, the Company believes a valuation allowance for its deferred tax assets is no longer necessary and has reversed its valuation allowance in the current year. As a result, in future years the Company's statement of income under U.S. GAAP will include income tax expense calculated in accordance with FAS 109, which the Company expects will result in an increase in income tax expense under U.S. GAAP. This U.S.-Canadian GAAP difference will, in all likelihood, be eliminated in 1997 as the Canadian Institute of Chartered Accountants (CICA) is expected to endorse a similar basis of accounting for income taxes for Canadian reporting purposes.

The Company has designated certain future U.S. dollar revenue streams as a hedge against the repayment of most of its long-term debt denominated in U.S. dollars, and as a result the related unrealized foreign currency translation gains or losses are deferred and recognized in net income at the earlier of the debt repayment or such time as the hedge ceases to be effective. Such foreign exchange gains or losses will be offset by foreign currency gains or losses resulting from the U.S. dollar revenue stream. Unrealized foreign currency gains or losses related to long-term debt denominated in U.S. dollars not covered by the hedge are deferred and amortized over the remaining life of the debt. Such deferred amounts are included in the consolidated balance sheet as part of Other assets and deferred charges.

Progress on strategic initiatives

Stages of progress achieved during the year 1996 on the Company's strategies were as follows:

Reducing costs

CN's principal cost reduction initiatives included labour downsizing, network rationalization, and improved asset utilization.

In 1996, the Company achieved its initial downsizing target, a workforce reduction of over 11,000 employees. In the fourth quarter, the Company committed to an additional 2,250 reductions commencing in the fourth quarter and to be completed during 1997.

The Canada Transportation Act was proclaimed on June 27 and it took effect on July 1, 1996. As anticipated, many obstacles to the rationalization process

were removed by the new legislation. The Company reacted immediately by designating, on July 2, some 2,100 miles of track to be rationalized over the next three years by way of transfer to shortline operators or abandonment. The Company remains committed to its original goal of rationalizing 4,000 low-density route miles and has established some 2,000 additional low-density route miles for rationalization by the end of 1999. Of this total, approximately 794 miles had been rationalized by year end 1996. Rationalization of low-density branch lines paves the way for the Company to concentrate its efforts on growth of traffic in the key higher-density corridors where it operates most efficiently.

Collective agreements were reached with the Brotherhood of Locomotive Engineers and the United Transportation Union representing train crews of the Grand Trunk Western Railroad, CN's major U.S. subsidiary. These agreements provide for: reduction of train crews to two persons; elimination of short-run crew changes in cross-border runs; and greater flexibility in road and yard jobs. The contracts will be effective until December 31, 1997.

CN and the Canadian Auto Workers have concluded an agreement on trades modernization. The agreement will reduce trade structures from six to three and will allow the Company the flexibility required to improve efficiency at line points and in back shop operations. This was a major issue during the last round of contract talks and was a bargaining objective of the Company.

In the area of equipment maintenance, three locomotive shops in eastern Canada were consolidated into one in the Toronto area. This will eliminate overcapacity and contribute further toward workforce reduction targets. In further moves to eliminate overcapacity and increase productivity and efficiency in equipment maintenance, the Company announced the consolidation of eastern railcar heavy equipment maintenance facilities in Toronto. Such maintenance was previously performed at six locations in eastern Canada. The Company also entered into an agreement with the General Motors Diesel Division (GM) to manage the maintenance of CN's core fleet of 511 high-horsepower mainline locomotives. The maintenance will be carried out by CN employees at Edmonton and Toronto under the management of GM technical representatives at each of those locations.

In early 1996, CN announced the streamlining of its western operations by paring the number of operating districts from five to three. The move is intended to cut costs, make better use of assets, and create a more efficient management structure by complementing similar changes made to eastern operations.

CN is continuing to make progress in its efforts to reduce transportation costs. The Company's program of extended runs has now been implemented, with the attendant cost reductions and productivity improvements. In addition, a further 88 locomotives were equipped with Beltpack technology. Conversion of yard operations to this new technology reduces train crew requirements significantly.

RailTex Inc. was the successful bidder for CN's rail line and operating assets of the former Detroit, Toledo & Ironton Railroad, running from Diann, Michigan, to Cincinnati, Ohio. CN has signed a letter of intent with RailTex for the sale. CN will retain certain access rights in this corridor under a haulage agreement with RailTex. The sale, which had been expected to be completed by year end, was closed on the 17th of February, 1997.

Improving customer service

With the implementation of the Service Reliability Strategy (SRS), a computer-based system for the control and monitoring of customers' shipments, CN's competitive position has been enhanced by providing innovative new capabilities to CN employees and customers. Employees have initiated over 3,000 enhancements to SRS to improve service and efficiency. Service scheduling processes and tools have been implemented across the country, providing customer-driven trip plans for loaded and empty railcar movements from origin to destination.

The Winnipeg Customer Support Centre opened during the year with a highly sophisticated customer service system utilizing integrated computer and telephone technologies. This was followed with new systems for managing demurrage, customs clearance, customer car orders, empty equipment management, and the generation of customized reports of CN service performance for our customers. CN customers and partners have also benefited from new EDI capabilities, improved direct access to information, and CN's implementation of the industry's first Internet car tracing capability.

Significant improvements in cash flow and revenue have been supported through enhancements to CN's new Revenue Management System and the implementation of all Class 1 railroads on the Interline Settlements System. The cost of technology at CN was reduced through the sale of microwave transmission facilities and the re-negotiation of computer and telephone switch contracts.

In July, CN and Illinois Central concluded an agreement providing seamless freight service between Western Canada and the Gulf of Mexico. This freight alliance is part of "The Superior Connection", a series of agreements involving CN and U.S. railroads such as Wisconsin Central, CSX Intermodal, and Illinois Central. The Superior Connection is an important Chicago–western Canada connection through Superior, Wisconsin. The new Illinois Central hook-up gives CN customers direct access from the port of Vancouver, British Columbia, to the ports of New Orleans, Louisiana, and Mobile, Alabama, including overnight service from Chicago. The service is covered by a single freight rate and invoice covering a shipment which may travel on different rail carriers.

Under a further agreement with Illinois Central, work commenced in 1996 on a new 75-acre CN intermodal terminal in the Chicago area. When completed in early 1997, this terminal will more than double CN's capacity, to 225,000 units per year. In addition to expanding CN's capacity for growth, the facility aims at improving transit times for both European and Pacific Rim traffic and for north-south freight shipments.

Targeting capital spending to develop a low-cost, highly reliable railroad

The Company invests in capital projects to support its strategic initiatives of cost reduction and service improvement. Two important strategic projects where significant progress was achieved during 1996 were the SRS and the Locomotive Upgrade Program. Implementation of the SRS was completed in 1996. The Company began to offer scheduled service on certain routes and, by the end of 1996, had made significant progress toward fully scheduled operations across the network. The service scheduling feature is designed to improve every aspect of service delivery. Under the Locomotive Upgrade Program undertaken in 1995, the Company planned to replace 543 aging locomotives with 394 new, high-productivity locomotives over the following 15 years. The Company took delivery of 105 of the new locomotives in 1996 and expects to take delivery of a further 75 new locomotives during 1997. With these acquisitions, the Company will have achieved nearly half of its 15-year plan in the first three years.

*f*ONOROLA Telecommunications LP of Montreal and Ledcor Industries Ltd. of Vancouver have agreed to begin construction of a fibre optic connection linking the cities of Vancouver, Calgary, Edmonton, Winnipeg, and Toronto, among others. CN will provide the rights-of-way for the major link between Edmonton and Toronto. Under the agreement, CN will obtain four free strands of fibre optic cable, which will provide significant benefits in terms of modernizing its communication and signaling system across the prairies and northern Ontario once the project is completed.

MANAGEMENT REPORT

The accompanying consolidated financial statements of Canadian National Railway Company and all information in this annual report are the responsibility of management and have been approved by the board of directors.

The financial statements have been prepared by management in conformity with Canadian generally accepted accounting principles. These statements include some amounts that are based on best estimates and judgments. Financial information used elsewhere in the annual report is consistent with that in the financial statements.

Management of the Company, in furtherance of the integrity and objectivity of data in the financial statements, has developed and maintains a system of internal accounting controls and supports an extensive program of internal audits. Management believes that this system of internal accounting controls provides reasonable assurance that financial records are reliable and form a proper basis for preparation of financial statements and that assets are properly accounted for and safeguarded.

The board of directors carries out its responsibility for the financial statements in this report principally through its audit and finance committee, consisting solely of outside directors. The audit and finance committee reviews the Company's annual consolidated financial statements and recommends their approval by the board of directors. Also, the audit and finance committee meets regularly with the Chief, Internal Audit, and with the shareholders' Auditors.

These consolidated financial statements have been audited by the shareholders' Auditors, KPMG, whose report is presented below.

Michael J. Sabia
Senior Vice-President and Chief Financial Officer

January 21, 1997

AUDITORS' REPORT

To the shareholders of
Canadian National Railway Company

We have audited the consolidated balance sheets of Canadian National Railway Company as at December 31, 1996 and 1995 and the consolidated statements of income, shareholders' equity and changes in financial position for each of the years in the three-year period ended December 31, 1996. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 1996 and 1995, and the results of its operations and the changes in its financial position for each of the years in the three-year period ended December 31, 1996, in accordance with generally accepted accounting principles.

KPMG

KPMG
Chartered Accountants

Raymond, Chabot, Martin, Paré

Raymond, Chabot, Martin, Paré
General Partnership
Chartered Accountants
(For the years ended December 31, 1995 and 1994)

Montreal, Canada,
January 21, 1997

CONSOLIDATED STATEMENT OF INCOME

Canadian National Railway Company

In millions *Year ended December 31*	1996	1995	1994
Revenues			
Industrial products	$ 866	$ 848	$ 830
Forest products	790	774	790
Grain and grain products	570	603	788
Coal, sulphur, and fertilizers	622	603	566
Intermodal	710	669	718
Automotive	402	412	406
Other	199	189	207
Total revenues	4,159	4,098	4,305
Operating expenses			
Labour and fringe benefits	1,407	1,502	1,646
Material	304	324	389
Fuel	314	277	276
Depreciation and amortization	194	231	256
Operating taxes	171	192	192
Equipment rental	216	194	180
Net car hire	108	117	96
Purchased services	450	444	445
Casualty and insurance	85	52	82
Other	300	325	286
Special charges *(Note 9)*	381	1,453	–
Total operating expenses	3,930	5,111	3,848
Operating income (loss)	229	(1,013)	457
Interest expense *(Note 10)*	(114)	(198)	(196)
Other income *(Note 11)*	20	100	27
Income (loss) from continuing operations before income taxes	135	(1,111)	288
Income tax (expense) recovery from continuing operations *(Note 12)*	(11)	19	(24)
Income (loss) from continuing operations	124	(1,092)	264
Discontinued operations (net of applicable income taxes) *(Note 13)* 86	18	7	(19)
Net income (loss)	$ 142	$(1,085)	$ 245
Earnings per share (Note 15)			

See accompanying notes to consolidated financial statements.

CONSOLIDATED BALANCE SHEET

Canadian National Railway Company

In millions December 31	1996	1995
Assets		
Current assets:		
Cash and cash equivalents	$ 106	$ 119
Accounts receivable *(Note 2)*	798	902
Material and supplies	158	209
Other	99	75
	1,161	1,305
Properties *(Note 3)*	4,869	4,650
Other assets and deferred charges	206	219
Total assets	$6,236	$6,174
Liabilities and shareholders' equity		
Current liabilities:		
Accounts payable and accrued charges *(Note 5)*	$ 929	$ 901
Current portion of long-term debt *(Note 7)*	27	288
Other	381	390
	1,337	1,579
Other liabilities and deferred credits *(Note 6)*	1,020	976
Long-term debt *(Note 7)*	1,499	1,313
Shareholders' equity (Note 8):		
Capital stock	2,012	2,012
Contributed surplus	190	190
Retained earnings	178	104
	2,380	2,306
Total liabilities and shareholders' equity	$6,236	$6,174

See accompanying notes to consolidated financial statements.

On behalf of the board:

David G.A. McLean
Director

Paul M. Tellier
Director

Canadian National Railway Company

In millions	Issued and outstanding common shares	Capital stock	Contributed surplus	Retained earnings	Total shareholders' equity
Balances December 31, 1993	5.9	$ 2,279	$ –	$ 133	$ 2,412
Net income		–	–	245	245
Balances December 31, 1994	5.9	2,279	–	378	2,657
Net loss		–	–	(1,085)	(1,085)
Capital reorganization *(Note 8(B))*:					
Stock split	74.1	–	–	–	–
Reduction in stated capital		(1,300)	489	811	–
Common shares issued	4.9	1,033	–	–	1,033
Dividend in kind		–	(248)	–	(248)
Costs related to sale of shares		–	(33)	–	(33)
Other transactions		–	10	–	10
Related income tax effect		–	(28)	–	(28)
Balances December 31, 1995	84.9	2,012	190	104	2,306
Net income		–	–	142	142
Dividends		–	–	(68)	(68)
Balances December 31, 1996	84.9	$ 2,012	$ 190	$ 178	$ 2,380

See accompanying notes to consolidated financial statements.

Canadian National Railway Company

In millions *Year ended December 31*	1996	1995	1994
Operating activities			
Income (loss) from continuing operations	$ 124	$(1,092)	$ 264
Non-cash items in income (loss):			
Depreciation and amortization *(Note 14(C))*	196	234	260
Special charges	365	1,415	–
Gain on disposal of rail subsidiary's operating assets	–	(39)	–
Gain on disposal of joint venture net assets	–	(5)	–
Changes in:			
Accounts receivable	73	(162)	(96)
Material and supplies	16	20	5
Accounts payable and accrued charges	50	(129)	123
Other net current assets and liabilities	30	47	(6)
Payments for workforce reduction	(307)	(245)	(118)
Other	5	(18)	(94)
Cash provided from continuing operations	552	26	338
Investing activities			
Additions to properties	(496)	(326)	(539)
Net proceeds from disposal of properties	64	82	30
Net proceeds from disposal of rail subsidiary's operating assets	–	50	–
Net proceeds from disposal of joint venture net assets	–	10	–
Other	1	(4)	1
Cash used by investing activities	(431)	(188)	(508)
Dividends paid to shareholders	(68)	–	–
Financing activities			
Issuance of long-term debt	213	3	443
Reduction of long-term debt	(294)	(814)	(167)
Issuance (redemption) of auction preferred stock	–	(271)	271
Issuance of capital stock *(Note 8)*	–	1,033	–
Costs related to the sale of shares	–	(33)	–
Cash (used by) provided from financing activities	(81)	(82)	547
Cash provided from (used by) discontinued operations *(Note 13)*	15	108	(50)
Net (decrease) increase in cash	(13)	(136)	327
Cash and cash equivalents (bank indebtedness), beginning of year	119	255	(72)
Cash and cash equivalents, end of year	$ 106	$ 119	$ 255

See accompanying notes to consolidated financial statements.

CN's revenues are derived from the movement of a balanced and diversified mix of commodities and products predominantly originating in Canada. The Company's network extends from Halifax to Vancouver and connects to the Chicago gateway through its subsidiary, Grand Trunk Corporation in the east, and through a haulage agreement linking Chicago to the Company's lines at Duluth in the west.

1 Summary of significant accounting policies

The consolidated financial statements are expressed in Canadian dollars and have been prepared in accordance with accounting principles generally accepted in Canada, which differ in certain respects from those in the United States as explained in Note 19. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of revenues and expenses during the reported period and the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates.

A. Principles of consolidation

The consolidated financial statements include the accounts of all subsidiaries together with the Company's investments in which it has joint control. These investments are accounted for using the proportionate consolidation method.

B. Revenues

Freight revenues are recognized based on the percentage of completed service method. Costs associated with movements are recognized as the service is performed. This accounting policy represents a change from prior years when freight revenues and related costs were recognized on the completion of the movements. The impact of this change in accounting policy is not material to the financial statements.

C. Foreign exchange

The Company's foreign operations are classified as integrated and are translated and accounted for on the following basis: monetary assets and liabilities are translated at the rates in effect at the balance sheet date, and non-monetary assets and liabilities are translated at historical rates. Revenues and expenses are translated at average rates during the year except for depreciation, which is translated at exchange rates prevailing when the related properties were acquired.

The Company's own foreign denominated assets and liabilities are accorded similar treatment. Revenues and expenses are translated at rates prevailing at the time of the transactions, except for revenues designated as a hedge against repayment of foreign denominated long-term debt, which are translated at the rate in effect at the inception of the debt.

Currency gains and losses are reflected in net income for the year, except for unrealized foreign currency gains and losses on long-term debt. The Company has designated certain future U.S. dollar revenue streams as a hedge against the repayment of most of its long-term debt denominated in U.S. dollars and has thus deferred reflecting the related unrealized foreign currency translation gains and losses in net income until the earlier of the debt repayment or such time as the hedge ceases to be effective. Such foreign exchange gains or losses will be offset by foreign currency gains or losses resulting from the U.S. dollar revenue stream. Unrealized foreign currency gains and losses related to long-term debt denominated in U.S. dollars not covered by the hedge are deferred and amortized over the remaining life of the debt. Such deferred amounts are included in the Consolidated Balance Sheet as part of Other assets and deferred charges.

D. Cash and cash equivalents

Cash and cash equivalents include highly liquid investments purchased three months or less from maturity and are stated at cost, which approximates market value.

E. Material and supplies

The inventory is valued at weighted average cost for ties and rails, latest invoice price for fuel and new materials in stores, and at estimated utility or sales value for usable secondhand, obsolete, and scrap materials.

F. Properties

Railway properties are carried at cost less accumulated depreciation including asset impairment write-downs. All costs of materials associated with the installation of rail, ties, ballast, and other track improvements are capitalized to the extent they meet the Company's definition of "unit of property". The related labour and overhead costs are also capitalized for the installation of new, non-replacement track. All other labour and overhead costs and maintenance costs are expensed as incurred. Related interest costs are charged to expense. The cost of depreciable assets retired or disposed of, less salvage value, is charged to accumulated depreciation, in accordance with the group plan of depreciation.

G. Depreciation

The cost of properties, net of asset impairment write-downs, is depreciated on a straight-line basis over their estimated useful lives as follows:

Asset class	Annual rate
Ties	2.18%–3.14%
Rails	1.93%–2.58%
Other track material	2.40%–3.32%
Ballast	2.21%–4.36%
Road locomotives	3.51%–4.30%
Freight cars	0.63%–4.22%
Buildings	0.78%–5.34%

H. Pensions

Pension costs are determined periodically by independent actuaries. Pension expense is charged to operations and includes:

(i) the cost of pension benefits provided in exchange for employees' services rendered during the year,

(ii) the amortization of past service costs over the expected average remaining service life of the employee group covered by the plans, and

(iii) the interest cost of pension obligations, the return on pension fund assets, and the amortization of experience gains and losses.

The pension plans are funded through contributions determined in accordance with the accrued benefit actuarial cost method.

I. Post-retirement benefits other than pensions

The Company accrues the cost of post-retirement benefits other than pensions, which include life insurance programs, medical benefits, supplemental pension allowances, and free rail travel benefits not covered in the Company's principal pension plans. The Company funds the benefits payable as they become due.

J. Financial instruments

Derivative financial instruments may be used from time to time by the Company in the management of its interest, foreign currency, and commodity exposures. Gains or losses on such instruments entered into for the purposes of hedging its risk exposures are deferred and amortized in income over the life of the hedged asset or liability. Income and expense related to financial instruments are recorded in the same category as that generated by the underlying asset or liability.

K. Environmental expenditures

Environmental expenditures that relate to current operations are expensed or capitalized as appropriate. Expenditures that relate to an existing condition caused by past operations, and which do not contribute to current or future revenue generation, are expensed. Liabilities are recorded when environmental assessments and/or remedial efforts are likely, and when the costs, based on a specific plan of action in terms of the technology to be used and the extent of the corrective action required to meet the Company's environmental policy, can be reasonably estimated.

2 Accounts receivable

In millions	*December 31*	1996	1995
Freight			
Trade		$433	$430
Accrued		145	229
Non-freight		250	274
		828	933
Provision for doubtful accounts		(30)	(31)
		$798	$902

3 Properties

In millions	*December 31, 1996*			*December 31, 1995*		
	Cost	Accumulated depreciation	Net	Cost	Accumulated depreciation	Net
Track and roadway	$ 6,561	$3,247	$3,314	$ 6,551	$3,298	$3,253
Buildings	833	497	336	816	481	335
Rolling stock	2,051	1,072	979	1,889	1,077	812
Other	758	518	240	754	521	233
	10,203	5,334	4,869	10,010	5,377	4,633
Discontinued operations						
AMF	–	–	–	53	36	17
CN France	–	–	–	2	2	–
	–	–	–	55	38	17
	$10,203	$5,334	$4,869	$10,065	$5,415	$4,650
Capital leases included in properties	$ 322	$ 40	$ 282	$ 133	$ 42	$ 91

4 Credit facilities

The Company has entered into credit agreements providing for committed revolving credit facilities of Cdn $300 million and U.S. $150 million for a two-year term arranged through a syndicate of financial institutions. The facilities provide for various types of loans at varying rates based on certain benchmark rates, including the Canadian Prime Rate, the U.S. Base Rate, the U.S. Federal Funds Effective Rate, and the London Interbank Offer Rate, and on the Company's credit rating at the time of drawdown. In 1996 and 1995, the Company had not drawn down on the credit facilities.

5 Accounts payable and accrued charges

In millions *December 31*	1996	1995
Current portion of workforce reduction provisions	$210	$219
Payroll-related accruals	167	178
Trade payables	153	171
Accrued operating leases	119	96
Accrued charges	69	52
Accrued interest on long-term debt	34	43
Other	177	142
	$929	$901

6 Other liabilities and deferred credits

In millions *December 31*	1996	1995
Workforce reduction provision, net of current portion *(A)*	$ 445	$378
Accrual for post-retirement benefits other than pensions *(B)*	126	124
Personal injury liability	96	100
Environmental liability, net of current portion	79	81
Deferred credits and other	274	293
	$1,020	$976

A. Workforce reduction provisions

The workforce reduction provisions, which cover employees in both Canada and the United States, are mainly comprised of severance payments which will be disbursed over a period of up to six years. Elements of the provisions include mainly early retirement incentives and bridging to early retirement. Payments for severance and the other elements of the provisions have reduced the provisions by $307 million for the year ended December 31, 1996 ($245 million for the year ended December 31, 1995). The special charge recorded in 1996 with respect to workforce reductions had the effect of increasing the aggregate provisions to $655 million at December 31, 1996 ($597 million as at December 31, 1995) (see Note 9(A)).

B. Post-retirement benefits other than pensions

(i) The following table shows the reconciliation of the plan's obligations to amounts accrued at the balance sheet dates. The Company uses a December 31 measurement date.

In millions December 31	1996	1995
Accumulated post-retirement benefit obligation:		
Retirees	$ 70	$ 65
Fully eligible active plan participants	50	55
	120	120
Unrecognized net gain	6	4
	$126	$124
Weighted-average discount rate	8.00%	7.67%
Weighted-average (long-term) salary increase	5.25%	5.25%

(ii) Components of net periodic post-retirement benefit cost applicable to continuing operations are as follows:

In millions Year ended December 31	1996	1995
Service cost	$ 3	$ 3
Interest cost	6	6
Net amortization and deferral	(7)	(4)
	$ 2	$ 5

7 Long-term debt

In millions December 31	Maturity	Currency in which payable	1996	1995
Bonds, debentures, and notes:				
Canadian National series:				
6½% 10-year Japanese yen notes *(A)*	Mar. 26, 1996	¥	$ –	$ 70
9⅝% 7-year notes	May 14, 1999	Cdn$	50	50
5⅜% 15-year Swiss franc bonds *(B)*	Aug. 22, 2000	CHF	99	99
8⅞% 15-year notes	May 21, 2001	Cdn$	150	150
8⅜% 25-year sinking fund debentures *(A)*	July 1, 2002	U.S.$	–	21
6⅝% 10-year notes	May 15, 2003	U.S.$	190	190
7% 10-year notes	Mar. 15, 2004	U.S.$	412	412
13% 20-year sinking fund debentures *(A)*	Nov. 15, 2004	Cdn$	–	71
12¼% 20-year sinking fund debentures *(A)*	May 1, 2005	Cdn$	–	104
7⅝% 30-year debentures	May 15, 2023	U.S.$	190	190
Other bonds			–	2
Total bonds, debentures, and notes (C)			1,091	1,359
Other:				
Mortgages and other *(D)*		Various	33	33
Amounts owing under equipment agreements *(E)*		Various	83	90
Capital lease obligations *(F)*		Various	291	92
Adjustment to current exchange rate		Various	32	32
Total other			439	247
Subtotal			1,530	1,606
Less:				
Current portion of long-term debt			27	288
Net unamortized discount and other			4	5
			31	293
			$1,499	$1,313

7 Long-term debt *(continued)*

A. During 1996, the Company redeemed $272 million of long-term debt, completing its program to redeem, repurchase, and defease $1,046 million of long-term debt. In December 1995, as part of this program, the Company effectively extinguished $401 million of its long-term debt through defeasance, by placing government securities in irrevocable trusts in sufficient amounts to satisfy the interest and maturing principal requirements of the specific debt obligations in a timely manner.

B. The August 22, 2000 bonds issued in Swiss francs (170 million CHF) bearing an interest rate of 5⅝% were effectively changed at their issue date to a $99 million Canadian dollar obligation through a currency swap agreement at an all-inclusive cost of 11.17%.

C. The Company's bonds, debentures, and notes are unsecured.

D. Mortgages and other loans bear interest at various rates.

E. Secured by rolling stock and payable by monthly or semi-annual installments over various periods to 2003 at interest rates ranging from 6% to 13¾%. The principal amounts are payable as follows: U.S. $22 million and Cdn $53 million as at December 31, 1996, U.S. $24 million and Cdn $57 million as at December 31, 1995.

F. Interest rates for these leases range from approximately 4½% to 17½% with maturity dates in the years 1997 through 2014. The imputed interest on these leases amounted to $32 million as at December 31, 1996, and $39 million as at December 31, 1995.

G. Principal repayments for the following fiscal years, including sinking fund repayments, repurchase arrangements, and capital lease repayments on debt outstanding as at December 31, 1996 are as follows:

Year	*In millions*	Amount
1997		$ 27
1998		29
1999		89
2000		141
2001		191
2002 and thereafter		1,049

H. The aggregate amount of U.S. debt payable in U.S. currency as at December 31, 1996 is U.S. $737 million (Cdn $1,010 million) and as at December 1995 is U.S. $646 million (Cdn $881 million).

8 Shareholders' equity

A. Authorized capital stock
The authorized capital stock of the Company is as follows:

- Unlimited number of Common Shares, without par value
- Unlimited number of Class A Preferred Shares, without par value issuable in series
- Unlimited number of Class B Preferred Shares, without par value issuable in series

B. Capital reorganization
During 1995, the CN Commercialization Act came into effect authorizing the continuance of the Company under the Canada Business Corporations Act (CBCA) and the sale of common shares of the Company owned by the Government of Canada. On November 28, 1995, the Government of Canada sold all its shares in the Company to the public. Prior to the sale of the shares, the Company carried on ordinary business transactions with various entities controlled by its previous shareholder on the same terms and conditions as transactions with unrelated parties.

Also during 1995, the Company reorganized its capital structure by: reducing its legal stated capital by an amount of $1,300 million, thereby eliminating the accumulated deficit of $811 million and creating contributed surplus of $489 million; changing the 5,868,786 common shares issued and outstanding into 79,999,999 common shares, constituting a 13.63-for-one stock split; and transferring, by way of a dividend in kind, the beneficial ownership of a substantial portion of the Company's net non-rail real estate assets, which included CN Tower, having a book value of $248 million. In addition, the Company issued 4,945,299 common shares for cash.

C. Employee share plan

As part of the public offering in 1995, eligible employees purchased shares under the employee share plan. The Company provided non-interest bearing loans of up to 90% of the share purchase price to eligible employees. The Company will issue to all employees who participated in the share participation offer a total of 586,176 common shares (the Matched shares) for no additional consideration after a minimum two year vesting period.

D. Stock options

The Company has implemented stock option plans for eligible managers to acquire common shares of the Company at a price equal to the market value of the common shares at the date of granting. One-third of the options (the conventional options) vest over four years and have a term of 10 years from the date of granting. Two-thirds of the options (the performance options) vest upon the attainment by the Company of targets relating to the operating ratio. These performance options are scheduled to expire in the years 2001 and 2002.

Details of the Company's stock options are as follows:

	Number of shares	Exercise price	Options exercisable
	In millions		*In millions*
Outstanding at January 1, 1995	Nil	N/A	Nil
Granted	1.0	$27.00	
Outstanding at December 31, 1995	1.0	$27.00	Nil
Granted	0.6	$37.04	
Canceled	(0.1)	$27.00–$37.04	
Outstanding at December 31, 1996	1.5	$27.00–$37.04	0.2

9 Special Charges

A. Workforce reductions

The Company recorded a $365 million charge to operations in the fourth quarter of 1996 for workforce reduction plans aimed at reducing future operating costs and increasing productivity. The charge includes severance and other payments to be made for approximately 2,250 reductions, 1,050 of which occurred in the fourth quarter of 1996 with the remainder planned to be completed before the end of 1997. Labour productivity initiatives span the entire organization with reductions in the administration, transportation, engineering, and equipment functions.

B. Debt reduction costs

The charge to operations of the costs to redeem, repurchase, or defease debt in 1996 and 1995 amounted to $16 million and $38 million, respectively.

C. Asset impairment

During the second quarter of 1995, the Company undertook an asset impairment analysis which indicated that the net carrying values of certain of its rail properties were impaired. As a result, on June 30, 1995, the Company recorded a charge to operations and an increase in accumulated depreciation of $1,300 million. The amount of the impairment was established by comparing the future undiscounted net cash flow related to the eastern operations with the carrying amount of the eastern rail properties.

D. Environmental accrual

During the second quarter of 1995, the Company completed a review of potential environmental costs and liabilities. As a result of this review, the Company recorded a charge to operations for future environmental costs of $88 million. The current portion of the provision giving rise to these charges is included in the Consolidated Balance Sheet as part of Other current liabilities and the balance as part of Other liabilities and deferred credits.

E. Other

Other 1995 special charges are comprised of a write-down of material and supplies of $14 million and a provision for legal actions in the amount of $13 million.

10 Interest expense

In millions Year ended December 31	1996	1995	1994
Interest on long-term debt	$110	$214	$212
Interest on short-term borrowings	7	4	1
Interest income	(3)	(20)	(17)
Total continuing operations	$114	$198	$196
Cash interest payments for continuing operations	$119	$240	$212

11 Other income

In millions Year ended December 31	1996	1995	1994
Gain on disposal of rail subsidiary's operating assets	$ –	$ 39	$ –
Gain on disposal of properties	26	44	22
Net rental income (loss)	(7)	1	(2)
Investment income	10	18	13
Other	(9)	(2)	(6)
	$ 20	$100	$ 27

12 Income Taxes

The Company's income tax (expense) recovery from continuing operations is as follows:

In millions Year ended December 31	1996	1995	1994
Combined basic Canadian federal and provincial tax rate (combined basic tax rate)	44.4%	41.9%	41.7%
Income tax (expense) recovery from continuing operations based on the combined basic tax rate	$ (60)	$ 466	$(120)
(Expense) recovery in taxes resulting from:			
Federal large corporations tax and other cash taxes	(11)	(13)	(12)
Gain on disposal of properties	5	6	3
Other	9	(9)	(7)
Application of prior years' losses not previously recognized	46	–	112
Losses for which a tax benefit has not been recognized	–	(431)	–
Income tax (expense) recovery from continuing operations	$ (11)	$ 19	$ (24)
Income tax (expense) recovery is represented by:			
Current	$ (17)	$ (13)	$ (12)
Income taxes related to dividend in kind and other	–	28	–
Income taxes related to discontinued operations	6	4	(12)
	$ (11)	$ 19	$ (24)
Cash payments for income taxes	$ 11	$ 13	$ 12

The Company has timing differences of approximately $1,700 million as at December 31, 1996 ($1,800 million as at December 31, 1995) for which benefits have not been recognized in the financial statements. These benefits are available to reduce taxable income of future years.

13 Discontinued operations

In late 1996, the Company sold all the shares of CN France S.A., a wholly owned subsidiary, to Scribe Gestion S.A. The net proceeds retained by the Company resulted in a gain of $14 million.

During 1995, the Company disposed of CN Real Estate and CN Tower by transferring beneficial ownership of a substantial portion of the Company's net non-rail real estate assets, by way of dividend in kind (see Note 8) and by selling the remaining assets for a gain before income taxes of $61 million.

In addition, in 1995, the Company undertook a formal plan to dispose of AMF Technotransport Inc., (AMF). In January 1996, AMF was sold to GEC Alsthom Canada.

During the last quarter of 1994, the Company entered into negotiations to dispose of its oil and gas assets in CN Exploration. The results of these operations were reclassified as discontinued operations as at December 31, 1994. During February 1995, the assets were sold for a gain before income taxes of $43 million.

A. Income (loss) from discontinued operations

Amounts included in the Consolidated Statement of Income are comprised as follows:

In millions *Year ended December 31*	1996	1995	1994
Net income (loss):			
AMF Technotransport	$ –	$ (12)	$ (21)
CN Exploration	–	1	–
CN Real Estate	–	1	–
CN Tower	–	2	3
CN France	4	1	(1)
Net income (loss) from discontinued operations	4	(7)	(19)
Gain on disposal of investment in CN France, net of taxes of $6 million	14	–	–
Gain on disposal of oil and gas assets, net of income taxes of $18 million	–	25	–
Gain on disposal of real estate assets, net of income taxes of $25 million	–	36	–
Provision for loss on disposal of AMF, net of income tax recovery of $33 million	–	(47)	–
	14	14	–
Discontinued operations (net of applicable income taxes)	$ 18	$ 7	$ (19)

B. Net assets of discontinued operations

Amounts included in the Consolidated Balance Sheet are comprised as follows:

In millions *December 31*	1996	1995
Current assets	$ –	$ 44
Properties	–	17
Total assets	–	61
Current liabilities	–	37
Long-term debt	–	1
Total liabilities	–	38
Net assets	$ –	$ 23

C. Net increase (decrease) in cash

Amounts included in the Consolidated Statement of Changes in Financial Position are comprised as follows:

In millions *Year ended December 31*	1996	1995	1994
Operating activities	$ (15)	$ 15	$ (11)
Investing activities	31	437	(40)
Financing activities	(1)	(344)	1
Cash provided from (used by) discontinued operations	$ 15	$ 108	$ (50)

14 Segmented information

A. Geographic areas

Virtually all of the Company's operations and assets are within Canada with the exception of U.S. rail operations.

B. International traffic

In addition to the revenue generated by U.S. rail operations, the Company derives revenue from Canadian rail operations originating or terminating on railroads in the United States. These revenues amounted to approximately $905 million in 1996, $750 million in 1995, and $765 million in 1994.

C. Additional information on segments

In millions *Year ended December 31*	1996	1995	1994
Revenues:			
Canadian rail	$ 3,583	$ 3,569	$ 3,766
U.S. rail	576	529	539
	$ 4,159	$ 4,098	$ 4,305
Operating income (loss):			
Canadian rail	$ 256	$ (822)	$ 459
U.S. rail	(27)	(191)	(2)
	$ 229	$(1,013)	$ 457
Income (loss) from continuing operations:			
Canadian rail	$ 144	$ (959)	$ 268
U.S. rail	(20)	(133)	(4)
	$ 124	$(1,092)	$ 264

14 Segmented information *(continued)*

C. Additional information on segments (continued)

In millions *Year ended December 31*	1996	1995	1994
Depreciation and amortization:			
Canadian rail *(i)*	$ 186	$ 221	$ 245
U.S. rail	10	13	15
	$ 196	$ 234	$ 260
Capital expenditures: (ii)			
Canadian rail *(iii)*	$ 464	$ 288	$ 503
U.S. rail	32	38	36
	$ 496	$ 326	$ 539

In millions *December 31*	1996	1995
Identifiable assets:		
Canadian rail	$ 5,830	$ 5,572
U.S. rail	406	541
	6,236	6,113
Discontinued operations	–	61
	$ 6,236	$ 6,174

(i) Includes $2 million (1995: $3 million; 1994: $4 million) depreciation and amortization of properties related to net rental income.

(ii) Represents additions to properties.

(iii) Includes $1 million (1995: $1 million; 1994: $11 million) additions of properties related to net rental income.

15 Earnings (loss) per share

Year ended December 31	1996	1995	1994
Basic earnings (loss) per share			
Income (loss) from continuing operations	$1.46	$(13.57)	$3.30
Net income (loss)	$1.67	$(13.49)	$3.06
Basic earnings per share (excluding special charges)			
Income from continuing operations	$5.95	$ 4.49	$3.30
Net income	$6.16	$ 4.57	$3.06
Weighted average number of common shares outstanding *(millions)*	84.9	80.4	80.0

Earnings (loss) per share has been calculated using the weighted average number of common shares outstanding during the year after giving retroactive effect to the stock split of November 9, 1995.

16 Pensions

The Company has retirement benefit plans covering substantially all its employees under which they are entitled to benefits at retirement age, generally based on compensation and length of service and/or contributions.

The actuarial valuations as at December 31, 1995 indicated a consolidated actuarial liability of $8,062 million and a consolidated actuarial asset value of $7,804 million. It is estimated that those amounts approximate $8,200 million and $8,100 million, respectively, at December 31, 1996. Subsequent actuarial valuations will determine the actuarial values at that date.

In millions *Year ended December 31*	1996	1995	1994
Pension costs	$ 48	$ 96	$ 96
Pension contributions	$ 81	$ 96	$ 95

The information below relates to the CN Pension Plan, the Company's main pension plan. The Company's other pension plans are not significant.

A. Description of plan

The CN Pension Plan is a contributory defined benefit pension plan that covers all CN employees. It provides for pensions based mainly on years of service and final average pensionable earnings and is generally applicable from the first day of employment. Indexation of pensions is provided after retirement through a gain (loss) sharing mechanism, subject to guaranteed minimum increases. An independent trust company is the Trustee of the Canadian National Railways Pension Trust Fund (CN Pension Trust Fund). As Trustee, the trust company performs certain duties which include holding legal title to the assets of the Fund and ensuring that the Company, as Administrator, complies with the provisions of the Plan and the related legislation.

B. Funding policy

Employee contributions to this plan are determined by the plan rules. Company contributions are in accordance with the requirements of the Government of Canada legislation, The Pension Benefits Standards Act 1985, and are determined by actuarial valuations conducted at least on a triennial basis. These valuations are made in accordance with legislative requirements and with the Recommendations of the Canadian Institute of Actuaries for the valuation of pension plans.

C. Description of fund assets

The assets of the CN pension plan are separately accounted for in the CN Pension Trust Fund. These assets consist of cash and short term investments, bonds, mortgages, Canadian and foreign equities, real estate, and oil and gas assets.

17 Major commitments and contingencies

A. Leases

The Company's commitments as at December 31, 1996, under capital and operating leases, totaled $279 million and $1,400 million, respectively, with annual net minimum payments in each of the five following fiscal years to 2001 and thereafter, as follows:

Year	*In millions*	Capital	Operating
1997		$ 18	$208
1998		19	183
1999		27	170
2000		11	148
2001		30	148
2002 and thereafter		174	543

B. Other commitments

As at December 31, 1996, the Company had commitments to acquire locomotives and freight cars at an aggregate cost of $138 million, rail at a cost of $26 million, and railway ties at a cost of $20 million.

C. Contingencies

In the normal course of its operations, the Company becomes involved in various legal actions, including claims relating to injuries and damage to property. The Company maintains provisions for such items which it considers to be adequate. While the final outcome with respect to actions outstanding or pending as at December 31, 1996 cannot be predicted with certainty, it is the opinion of management that their resolution will not have a material adverse effect on the Company's financial position.

On July 20, 1995, the Company was advised by counsel to the National Council of CN Pensioners' Associations Inc. (the "National Council") that the latter intended to commence proceedings against the Company seeking payment of approximately $175 million, plus interest, to the CN Pension Trust Fund in connection with allegedly improper contribution holidays taken in the 1983 and 1984 fiscal periods. Any such payment, if required, would reduce the unfunded liability of the CN Pension Plan. The Company has investigated the claim as well as the relevant documentation and the current state of relevant law and believes that it has a reasonable and meritorious defense against the claim. On October 6, 1995, the Company received a draft complaint regarding this claim and a related claim seeking an order requiring that the CN Pension Plan be fully funded. The Company intends to vigorously defend in all competent forums any action which may be commenced by the National Council, or others, in this regard.

D. Environmental matters

The Company's operations are subject to extensive federal, provincial, state, municipal, and local regulation under environmental laws and regulations concerning, among other things, emissions into the air, discharges into waters, the generation, handling, storage, transportation, treatment and disposal of waste, hazardous substances, and other materials, decommissioning of underground and aboveground storage tanks, and soil and groundwater contamination. A risk of environmental liability is inherent in the railroad and related transportation operations, real estate

17 Major commitments and contingencies *(continued)*

ownership, operation, or control, and other commercial activities of the Company with respect to both current and past operations. As a result, the Company will incur significant compliance and capital costs, on an ongoing basis, associated with environmental regulatory compliance and clean-up requirements in its railway operations and relating to its past and present ownership, operation, or control of real property.

While the Company believes that it has identified the costs likely to be incurred in the next several years for environmental matters, the Company's ongoing efforts to identify potential environmental concerns that may be associated with its properties may lead to future environmental investigations, which may result in the identification of additional environmental costs and liabilities. The magnitude of such additional liabilities and the costs of complying with environmental laws and containing or remediating contamination cannot be reasonably estimated due to:

(i) the lack of specific technical information available with respect to many sites;

(ii) the absence of any government authority, third-party orders, or claims with respect to particular sites;

(iii) the potential for new or changed laws and regulations and for development of new remediation technologies and uncertainty regarding the timing of the work with respect to particular sites;

(iv) the ability to recover costs from any third parties with respect to particular sites; and,

therefore the likelihood of any such costs being incurred or whether such costs would be material to the Company cannot be determined at this time. Therefore, there can be no assurance that material liabilities or costs related to environmental matters will not be incurred in the future or that the Company's liquidity will not be adversely impacted by such environmental liabilities or costs. Although the effect on operating results and liquidity cannot be reasonably estimated, management believes, based on current information, that environmental matters will not have a material adverse effect on the Company's financial condition or competitive position. Costs related to any future remediation will be accrued in the year in which they become known.

As at December 31, 1996, the Company had aggregate accruals for environmental costs of $87 million ($98 million at December 31, 1995). In addition, $11 million was charged to the provision for environmental costs in 1996, $9 million in 1995, and nil in 1994. Related environmental capital expenditures were $13 million for 1996, $5 million in 1995, and $5 million in 1994. The Company expects to incur capital expenditures relating to environmental matters of approximately $16 million in each of 1997 and 1998 and $11 million in 1999. The Company has not included any reduction in costs for anticipated recovery from insurance.

18 Financial instruments

The Company has entered into forward exchange contracts (currency swaps) with respect to certain obligations denominated in currencies other than Canadian and U.S. dollars in connection with existing indebtedness. These forward exchange contracts act as a hedge to effectively fix the amount of Canadian dollars required over the term of the debt to make all necessary payments in the foreign currency of issue. The Company has not incurred any significant net gains or losses in respect of these transactions and does not currently utilize other derivative financial instruments. Losses due to nonperformance by the counterparties to its foreign currency swaps are not anticipated. Collateral or other security to support financial instruments subject to credit risk is usually not obtained, but the credit standing of counterparties is constantly monitored.

Generally accepted accounting principles define the fair value of a financial instrument as the amount at which the instrument could be exchanged in a current transaction between willing parties. The Company uses the following methods and assumptions to estimate the fair value of each class of financial instruments for which the carrying amounts are included in the Consolidated Balance Sheet under the following indicated captions:

A. Cash and cash equivalents, trade receivables, trade payables, and other current liabilities:
The carrying amounts approximate fair value because of the short maturity of those instruments.

B. Other assets and deferred charges:
Investments: The Company has various debt and equity investments for which the carrying value approximates the fair value of these investments.

C. Long-term debt:
The fair value of the Company's long-term debt is estimated based on the quoted market prices for the same or similar debt instruments.

The following table presents the carrying amounts and estimated fair values of the Company's financial instruments as at December 31, 1996 and 1995 for which the carrying value is not disclosed on the Consolidated Balance Sheet or for which the carrying amounts are different than the fair values.

In millions	*December 31, 1996*		*December 31, 1995*	
	Carrying amount	Fair value	Carrying amount	Fair value
Financial assets				
Investments	$ 59	$ 59	$ 60	$ 60
Financial liabilities				
Long-term debt	$1,499	$1,538	$1,313	$1,380

19 Reconciliation of Canadian and United States generally accepted accounting principles

The consolidated financial statements of Canadian National Railway Company are expressed in Canadian dollars and are prepared in accordance with Canadian generally accepted accounting principles (GAAP), which conform, in all material respects, with those generally accepted in the United States except as described below:

A. Reconciliation of net income

(i) Foreign exchange
U.S. GAAP requires immediate absorption in income of unrealized foreign currency exchange gains and losses on long-term monetary items with a fixed or ascertainable life, whereas Canadian accounting principles require that these unrealized gains and losses be deferred and amortized. In addition, under U.S. GAAP, future revenue streams from operations do not qualify as a hedge of long-term debt denominated in U.S. dollars.

(ii) Pension costs
Canadian GAAP requires that the discount rate used should represent management's best estimate of the long-term rate of return on the pension fund assets. Under U.S. GAAP, the discount rate to be used should reflect the rate at which the pension benefits can be effectively settled at the date of the financial statements.

(iii) Interest
The Company generally expenses interest costs related to the construction of properties. U.S. GAAP requires that this interest cost be capitalized.

(iv) Loss on extinguishment of long-term debt
Under U.S. GAAP, the loss on extinguishment of long-term debt, which is included in special charges for Canadian GAAP purposes, would have been treated as an extraordinary item.

(v) Stock-based compensation
U.S. GAAP requires the measurement and recognition of compensation expense related to stock-based compensation. The Company has accounted for stock-based compensation for U.S. GAAP purposes in accordance with APB Opinion 25. The difference between compensation expense measured in accordance with APB Opinion 25 and the amount which would have been recognized under FAS 123 is not material. There are no similar requirements under Canadian GAAP.

19 Reconciliation of Canadian and United States generally accepted accounting principles *(continued)*

(vi) Income taxes

U.S. GAAP requires the use of the asset and liability method for accounting for income taxes (see Note 19(D)). Under the asset and liability method, the change in the net deferred tax asset (liability) is to be included in income from continuing operations.

(vii) The application of U.S. GAAP would have the following effects on the net income (loss) as reported:

In millions *Year ended December 31*	1996	1995	1994
Income (loss) from continuing operations–Canadian GAAP	$124	$(1,092)	$264
Adjustments (net of applicable income taxes) in respect of:			
Foreign exchange	6	33	(30)
Pension costs	4	(1)	(8)
Capitalization of interest	–	5	4
Loss on extinguishment of long-term debt	16	38	–
Compensation expense related to stock-based compensation	(14)	–	–
Income tax recovery	708	–	–
Income (loss) from continuing operations, before extraordinary item–U.S. GAAP	844	(1,017)	230
Extraordinary item–loss on extinguishment of long-term debt	(16)	(38)	–
Income (loss) from continuing operations–U.S. GAAP	828	(1,055)	230
Discontinued operations	18	7	(19)
Net income (loss)–U.S. GAAP	$846	$(1,048)	$211

B. Earnings (loss) per share:

(i) Primary earnings (loss) per share

U.S. GAAP requires the use of the treasury stock method for common stock equivalents to compute the weighted average number of common shares outstanding for the period. The use of the treasury stock method for the Matched shares and stock options issued in 1995 and 1996 have been considered in the earnings per share figures for 1996 as computed under U.S. GAAP.

Year ended December 31	1996	1995	1994
Primary earnings (loss) per share:			
Income (loss) from continuing operations, before extraordinary item–U.S. GAAP	$ 9.83	$(12.64)	$2.88
Extraordinary item–loss on extinguishment of long-term debt	(0.19)	(0.47)	–
Income (loss) from continuing operations–U.S. GAAP	$ 9.64	$(13.11)	$2.88
Net income (loss)–U.S. GAAP	$ 9.85	$(13.03)	$2.64
Weighted average number of common shares outstanding *(millions)*–U.S. GAAP	85.9	80.4	80.0

(ii) Supplementary earnings (loss) per share

Supplementary earnings (loss) per share is provided to show the effect on earnings (loss) per share if debt were repurchased, redeemed, or defeased as at the beginning of the year. Income (loss) from continuing operations and net income (loss) used to compute supplementary earnings (loss) per share have been adjusted for a reduction in interest expense. The computation of supplementary loss per share for 1995 is based on the weighted average number of shares outstanding assuming the issuance of common stock (for which proceeds were used to redeem debt) took place at January 1, 1995.

Year ended December 31	1996	1995
Supplementary earnings (loss) per share:		
Income (loss) from continuing operations, before extraordinary item–U.S. GAAP	$ 9.87	$(11.37)
Extraordinary item–loss on extinguishment of long-term debt	(0.19)	(0.47)
Income (loss) from continuing operations–U.S. GAAP	$ 9.68	$(11.84)
Net income (loss)–U.S. GAAP	$ 9.89	$(11.76)
Weighted average number of common shares outstanding *(millions)*–U.S. GAAP	85.9	81.5

(iii) Earnings (loss) per share (excluding special charges)

Earnings (loss) per share excluding special charges as disclosed in Note 15 would not be presented under U.S. GAAP.

C. Reconciliation of significant balance sheet items

(i) Employee share purchase loans

Amounts receivable under employee share purchase loans are included in Other current assets for Canadian GAAP purposes. For U.S. GAAP purposes, these amounts would be classified as a reduction of Shareholders' equity.

(ii) Joint ventures

Interests in joint ventures are recognized using the proportionate consolidation method for Canadian GAAP. Under U.S. GAAP, joint ventures are accounted for using the equity method.

(iii) Shareholders' equity

As permitted under Canadian GAAP, the Company eliminated its accumulated deficit of $811 million as of June 30, 1995 through a reduction of the capital stock in the amount of $1,300 million and created a contributed surplus of $489 million. Such a reorganization within shareholders' equity is not permitted under U.S. GAAP.

Under Canadian GAAP, the dividend in kind declared in 1995 (with respect to land transfers) and other capital transactions were deducted from Contributed surplus. For U.S. GAAP purposes, these amounts would have been deducted from Retained earnings.

Under Canadian GAAP, costs related to the sale of shares have been deducted from Contributed surplus. For U.S. GAAP purposes, these amounts would have been deducted from Capital stock.

(iv) The application of U.S. GAAP would have a significant effect on the following balance sheet items as reported:

In millions December 31	1996	1995
Current assets–Canadian GAAP	$ 1,161	$ 1,305
Joint ventures	(23)	(25)
Employee share purchase loans receivable	(16)	(27)
Deferred income tax asset	186	–
Current assets–U.S. GAAP	$ 1,308	$ 1,253
Properties–Canadian GAAP	$ 4,869	$ 4,650
Joint ventures	(57)	(58)
Other	15	16
Properties–U.S. GAAP	$ 4,827	$ 4,608

In millions December 31	1996	1995
Other assets and deferred charges–Canadian GAAP	$ 206	$ 219
Unrealized exchange loss on long-term debt	(32)	(32)
Joint ventures	7	23
Prepaid pension costs	4	–
Deferred income tax asset	522	–
Other assets and deferred charges–U.S. GAAP	$ 707	$ 210
Current liabilities–Canadian GAAP	$ 1,337	$ 1,579
Joint ventures and other	(18)	(8)
Current liabilities–U.S. GAAP	$ 1,319	$ 1,571
Other liabilities and deferred credits–Canadian GAAP	$ 1,020	$ 976
Accrued pension liability	–	17
Joint ventures and other	1	(10)
Other liabilities and deferred credits–U.S. GAAP	$ 1,021	$ 983
Long-term debt–Canadian GAAP	$ 1,499	$ 1,313
Joint ventures and other	(39)	(39)
Long-term debt–U.S. GAAP	$ 1,460	$ 1,274
Capital stock–Canadian GAAP	$ 2,012	$ 2,012
Capital reorganization	~~1,300~~	1,300
Employee share purchase loans receivable 54	(16)	(27)
Costs related to the sale of shares	~~(33)~~	(33)
Capital stock–U.S. GAAP	$ 3,263	$ 3,252
Contributed surplus–Canadian GAAP	$ 190	$ 190
Capital reorganization	~~(489)~~	(489)
Dividend in kind with respect to land transfers	~~248~~	248
Costs related to the sale of shares	~~33~~	33
Other transactions and related income tax effect	~~18~~	18
Contributed surplus–U.S. GAAP	$ –	$ –
Retained earnings–Canadian GAAP	$ 178	$ 104
Capital reorganization	~~(811)~~	(811)
Dividend in kind with respect to land transfers	~~(248)~~	(248)
Other transactions and related income tax effect	~~(18)~~	(18)
Current year adjustments to net income	704	37
Cumulative effect of prior years' adjustments to income 112	(36)	(73)
Deficit–U.S. GAAP	$ (231)	$(1,009)

19 Reconciliation of Canadian and United States generally accepted accounting principles *(continued)*

D. Income taxes

The Company follows the deferral method of accounting for income taxes in accordance with Canadian GAAP, which relates the provision for income taxes to the accounting income for the period. Under the deferral method, the amount by which the tax provision differs from the amount of taxes currently payable is considered to represent the deferring to future periods of benefits obtained or expenditures incurred in the current period and accordingly is computed at current tax rates. The accumulated tax allocation debit or credit balance is not adjusted to reflect subsequent changes in tax rates. In the United States, Statement of Financial Accounting Standards No. 109 (FAS 109) requires the use of the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred income taxes are recognized for the future tax consequences attributable to differences between the financial statement carrying values and their respective tax bases. Deferred tax assets must be evaluated and realization must be considered "more likely than not", otherwise a valuation allowance must be provided. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is included in income in the period that includes the enactment date.

The Company has analyzed the sources and expected reversal periods of its deferred tax assets and liabilities and has evaluated all relevant factors. The Company believes that the continuation of certain positive trends, including net income (excluding special charges) for the current year and the previous two years, will result in the utilization of the tax loss carryforwards over a shorter period of time than had been projected in previous years. Additionally, the Company believes that the tax benefits attributable to deductible temporary differences will also be realized as a result of future taxable income. Accordingly, the Company believes that the valuation allowance previously provided for its deferred tax assets is no longer necessary and has reversed its valuation allowance in the current year.

In millions December 31	1996	1995
Assets		
Loss carryforwards	$ 264	$ 344
Workforce reduction provisions	249	242
Accruals and tax reserves–net	55	84
Post-retirement benefits	42	50
Properties	98	–
Loss on disposal of AMF Technotransport Inc.	–	33
Other	–	57
	708	810
Liabilities		
Properties	–	39
	–	39
Total net deferred tax asset before valuation allowance	708	771
Valuation allowance	–	(771)
Total net deferred tax asset	708	–
Less: current portion	186	–
Total net deferred tax asset–long-term portion	$ 522	$ –

E. Pension costs and obligation

The disclosures required by Statement of Financial Accounting Standards No. 87, Employers' Accounting for Pensions, are as follows:

(i) Assumptions

The following assumptions were used in determining the actuarial present value of the projected benefit obligation for U.S. GAAP:

Year ended December 31	1996	1995	1994
Discount rate	7.50%	7.75%	7.75%
Expected long-term salary increases	4.50%	5.25%	5.25%
Long-term rate of return on plan assets	8.40%	7.75%	7.75%

(ii) Components of annual pension cost

In millions *Year ended December 31*	1996	1995	1994
Service cost for benefits earned in the year	$ 45	$ 47	$ 49
Interest cost on projected obligation	611	586	584
Actual return on plans' assets	(1,392)	(926)	145
Net amortization and deferrals *	780	390	(674)
Pension costs–U.S. GAAP	$ 44	$ 97	$ 104

* *All experience gains (losses), including those in the 10% corridor, are amortized.*

(iii) Funding status

In millions *December 31*	1996	1995
Actuarial present value of benefit obligation:		
Vested	$7,672	$7,228
Non-vested	268	192
	7,940	7,420
Effect of projected future salary increases	488	487
Projected benefit obligation	8,428	7,907
Pension fund assets at market value	9,279	8,293
Pension fund assets in excess of projected benefit obligation	851	386
Unamortized portion of net obligation at January 1, 1989 **	142	166
Unamortized prior service cost **	10	8
Unamortized net gain**	(994)	(577)
Prepaid (accrued) pension cost–U.S. GAAP	$ 9	$ (17)

** *Amortized on a straight-line basis over expected average remaining service lives of employees (15 years prior to 1991, 12 years from 1991 to 1994, and 11 years thereafter)*

20 Comparative figures

Certain figures previously reported for 1995 and 1994 have been reclassified to conform with the basis of presentation adopted in the current year.

General review

Trustee

Montreal Trust Company of Canada (Montreal Trust) is the Trustee of the Canadian National Railways Pension Trust Fund (CN Pension Trust Fund). As Trustee, Montreal Trust performs certain duties which include holding legal title to the assets of the Fund and ensuring that the Canadian National Railway Company (CN), as Administrator, complies with the provisions of the CN Pension Plan, the CN 1935 Pension Plan, and the Pension Benefits Standards Act, 1985 and its regulations. The cheques and direct deposit statements in respect of these plans are issued in the name of Montreal Trust, Trustee of the CN Pension Trust Fund.

Administration of the pension plans

Overall accountability for the pension and benefit administration is the responsibility of CN. William M. Mercer Limitée, an employee benefits consulting firm, performs agreed-on pension and benefit administration services on behalf of CN.

Indexation of pension benefits

As a result of the indexation agreement negotiated with the railway unions in 1989 and improvements to such agreement negotiated in 1992, approximately 42,000 retirees and surviving spouses received permanent pension increases in 1996. These increases amounted to 0.55% on the first $1,625 of the basic CN monthly pension, with a guaranteed minimum monthly pension increase of $9.00 for eligible retirees and $4.50 for eligible surviving spouses, respectively.

Under this indexation agreement, effective January 1, 1989, 50% of the experience gains or losses related to pensioners are accounted for separately. These net experience gains are used exclusively to pay for indexation of pensions above the minimum up to the maximum annual amount. The maximum annual indexation for eligible retirees and survivors is 50% of the increase in the Consumer Price Index (CPI) to a maximum increase in CPI of 6%, with an annual limit on the amount of pension which can be indexed. In 1996, the basic eligibility requirements to qualify for indexation were to have been retired for five complete calendar years and to have reached age 63.

Annual pension statements

As required by the Pension Benefits Standards Act, 1985 and to keep employees who are members updated annually on their personal entitlement, personalized pension statements were prepared as at December 31, 1995 and distributed by June 1996.

Services to pensioners

A. Direct deposit:

The Direct Deposit System (DDS) is available to all retirees and survivors. Under this system, the monthly pension benefit is deposited directly into the individual's personal account, and an itemized pension pay stub is sent to that individual. About 42,000 pensioners used this service in 1996.

B. Toll-free help lines:

Approximately 51,000 calls were received in 1996 through the central toll-free help line (1-800-361-0739). Staff handling the toll-free telephone line have ready access to records and information required for quick, efficient and accurate responses to most callers' needs – in both of Canada's official languages.

Trustee's report

To the Administrator and the Members of the CN 1935 Pension Plan and the CN Pension Plan

We, Montreal Trust Company of Canada, are the Trustee of the Canadian National Railways Pension Trust Fund ("CN Pension Trust Fund"). As Trustee, we have examined the systems, procedures and internal controls used in respect of the custody, investment, and administration of the assets of the CN Pension Trust Fund, the administration of the CN 1935 Pension Plan ("1935 Plan") and the CN Pension Plan, and the performance of Canadian National Railway Company ("CN") as Administrator of the 1935 Plan and the CN Pension Plan for the year ended December 31, 1996.

Our examination included such tests and procedures as we considered necessary in the circumstances taking into consideration the requirements of the Trust Deed and our experience in the Canadian pension industry.

In our opinion, based on the reasonable, but not absolute, degree of assurance obtained from our examination, the aforementioned systems, procedures and internal controls, used by CN as Administrator, operated effectively during the year ended December 31, 1996, and complied with the requirements of the Pension Benefits Standards Act, 1985 and its Regulations.

Montreal Trust Company of Canada
Trustee of the Canadian National Railways Pension Trust Fund

Montreal, January 21, 1997

Actuary's report

To the Trustee
Canadian National Railways Pension Trust Fund

We have conducted actuarial valuations as at December 31, 1995 for the CN Pension Plan and the CN 1935 Pension Plan.

As at December 31, 1995, these valuations revealed a consolidated actuarial liability of $8,062 million, a consolidated unfunded actuarial liability of $258 million and required consolidated Company contributions representing $79 million in 1996. The next actuarial valuations will be conducted as at December 31, 1998, at the latest.

In my opinion, for the purposes of the valuations,

- the data on which these valuations were based were sufficient and reliable,
- the assumptions are, in aggregate, appropriate; and
- the methods employed in the valuations are appropriate.

The valuations have been prepared, and my opinions given, in accordance with accepted actuarial practice.

Bernard Morency
Fellow of the Canadian Institute of Actuaries
William M. Mercer Limitée

Montreal, January 21, 1997

Auditor's report

To the Board of Directors

We have audited the consolidated statement of net assets of the CN Pension Plan and the CN 1935 Pension Plan as at December 31, 1996, and the consolidated statement of changes in net assets for the year then ended. These financial statements are the responsibility of the Administrator. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Administrator, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the net assets of the CN Pension Plan and the CN 1935 Pension Plan as at December 31, 1996, and the changes in their net assets for the year then ended in accordance with generally accepted accounting principles.

KPMG

KPMG
Chartered Accountants

Montreal, Canada
January 21, 1997

CONSOLIDATED STATEMENT OF NET ASSETS AT MARKET VALUE

The CN Pension Plan and the CN 1935 Pension Plan

In millions *As at December 31*	1996	1995
Bonds	$3,008	$2,941
Mortgages	119	97
Real estate	384	390
Oil and gas	222	235
Equities	4,491	3,468
Cash and short-term investments	974	1,116
	9,198	8,247
Accounts receivable – Canadian National Railway Company	6	6
Other net assets (liabilities)	(20)	46
	$9,184	$8,299

See accompanying notes to consolidated financial statements.

On behalf of the board:

David G.A. McLean
Director

Paul M. Tellier
Director

CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS AT MARKET VALUE

The CN Pension Plan and the CN 1935 Pension Plan

In millions — *Year ended December 31*	1996	1995
Net assets at market value, beginning of year	$8,299	$7,802
Investment income		
Bonds	229	233
Mortgages	9	10
Real estate	13	20
Oil and gas	28	22
Equities	71	78
Short-term investments	46	78
	396	441
Less administrative expenses	(9)	(9)
Investment income before gains on sales of investments	387	432
Gains on sales of investments	431	121
Total investment income	818	553
Unrealized appreciation in value of investments	565	380
Contributions		
Employees	79	86
Company	79	94
Total contributions	158	180
Disbursements for members		
Pension benefits paid	(548)	(540)
Refunds	(70)	(67)
Total disbursements for members	(618)	(607)
Transfers	(38)	(9)
Net increase	885	497
Net assets at market value, end of year	$9,184	$8,299

See accompanying notes to consolidated financial statements.

1 Description of plans

These consolidated financial statements cover two pension plans, the CN Pension Plan and the CN 1935 Pension Plan (CN Plans), and include the accounts of the Canadian National Railways Pension Trust Fund and its wholly owned companies. All references in these financial statements to the "Company" refer to Canadian National Railway Company, which is the Administrator of the CN Plans. The CN 1935 Pension Plan is for a closed group of members and represents less than 1% of the pension obligation of the plans. Therefore, the following is a summarized description of the CN Pension Plan only. Please refer to the rules of the CN Pension Plan for additional information.

A. General

The CN Pension Plan (Plan) is a contributory defined benefit pension plan generally applicable for new employees from the first day of employment. Under this Plan, employees contribute between 5.48% and 5.88% of earnings up to the Year's Maximum Pensionable Earnings (YMPE) under the Canada or Quebec Pension Plan and between 6.98% and 7.38% of earnings in excess of the YMPE up to a maximum of $6,319 in 1996. Participants are not required to make contributions after 35 years of pensionable service. Company contributions are determined on the basis of actuarial valuations done at least on a triennial basis in accordance with the requirements of the Pension Benefits Standards Act, 1985 and regulations thereunder.

B. Pensions

Pensions are based on the employee's average pensionable earnings for the best five consecutive calendar years or the last 60 months of employment at the rate of 2% for each year of pensionable service prior to January 1, 1966, 1.3% for each year of pensionable service thereafter up to the average YMPE over the last 60 months, and 2% of the excess of such average pensionable earnings over the average YMPE. The maximum annual pension payable is $1,715 multiplied by the pensionable service of the member. Pensionable service is limited to 35 years.

C. Retirement age

The normal retirement age is 65. However, employees with 85 points (age plus pensionable service) and with the Company's consent are entitled to an early retirement pension without reduction as long as they are at least 55 years of age. Furthermore, employees with less than 85 points can retire anytime from age 55 with a reduction in their pension of 0.5% for each month (6% per year) between their date of retirement and their 65th birthday.

D. Disability pensions

A member with 10 years of pensionable service who is either declared unfit to perform his (her) usual employment with the Company due to a permanent disability which occurred prior to 1992, or is declared totally and permanently disabled due to a disability which occurred after 1991, may apply for an immediate unreduced pension. Any declarations in respect of a member's disability are the responsibility of CN's System Director of Occupational Health Services.

E. Pre-retirement survivors' pensions and death refunds

A survivor's pension is payable to the eligible spouse of a member who had a minimum of two years of plan membership upon his (her) death. Otherwise, a death refund is payable to the spouse, or, if there is no spouse, to the estate of the member.

F. Post-retirement survivors' pensions and estate settlements

Upon death of a retiree who had an eligible spouse at retirement, either 50% or 60% of the basic pension of the retiree is payable to that spouse during his (her) lifetime depending on the option elected at retirement. The survivor pension is guaranteed for the first 10 years after retirement. If the retiree and the surviving spouse, if any, die in the first 10 years after retirement, the survivor pension will be payable to the estate of the retiree until the 10-year period is over.

G. Termination benefits

Upon termination of service, a member is entitled to either his (her) contributions with interest or to the value of his (her) benefits accrued under the plan or to a deferred pension or a combination of the above, depending on his (her) age, pensionable service, and years of membership at termination.

H. Income taxes

The Plan is registered under the Income Tax Act and regulations. Contributions to the Plan are tax deductible, and investment income of the Canadian National Railways Pension Trust Fund is not taxable in Canada. Investment income from some foreign countries is subject to withholding taxes which are either fully or partially recovered.

2 Summary of significant accounting policies

A. Basis of presentation

These consolidated financial statements are prepared on a market value basis, in accordance with generally accepted accounting principles for pension plans as recommended by the Canadian Institute of Chartered Accountants, and present the aggregate financial position of the CN Plans as a separate financial reporting entity independent of the sponsor and plan members. The statements are prepared to assist plan members and others in reviewing the activities of the CN Plans for the year, but they do not portray the funding requirements of the plans or the benefit security of individual members.

B. Valuation of net assets

Market value is determined using publicly quoted prices where available. When such prices are not available, market values are estimated on the basis of: the present value of estimated future cash flows, the market value of comparable assets, or the breakup value of underlying assets.

Valuation of net assets by category is as follows:

(i) Bonds are valued using the closing market bid as at December 31.

(ii) Mortgages are valued using current market yields of financial instruments of similar maturity and at appropriate spreads from instruments of comparable quality.

(iii) Real Estate consists of land, buildings, and equities. Land is valued using the market value of comparable assets, and buildings are valued using the present value of estimated future cash flows and the market value of comparable assets. Independent valuations of land and buildings are performed triennially. Equities are valued using closing market quotations as at December 31.

(iv) Oil and gas reserves are valued using the present value of estimated future net cash flows, which are based on projected production, prices, and costs. Land is valued using the market value of comparable assets. Trust units are valued using the closing market price as at December 31.

(v) Equities are valued using the closing market price as at December 31.

(vi) Short-term investments are valued at cost, which approximates market value.

(vii) Listed derivative financial instruments are valued using the market settlement price as at December 31. Unlisted derivative financial instruments are valued using the present value of future cash flows determined by using closing market levels and interest rates for instruments of similar maturity and credit risk.

C. Income recognition

Dividends are accrued on the ex-dividend date; income from other investments is accrued as earned. Gains or losses on sales of investments are recognized on the dates of sales and are calculated on the basis of the average cost of the assets.

D. Foreign exchange

Investments denominated in foreign currencies are translated using current rates as at December 31 or

at the forward foreign exchange contract rates for investments that are hedged. Foreign dividends and interest income are translated at the rates prevailing when accrued.

E. Change in market value

The change in market value has been segregated in the consolidated statement of changes in net assets between gains or losses on the sales of investments during the year and the unrealized appreciation (depreciation) in the value of investments, which is the balance of the change in market value of investments for the year.

F. Contributions

Contributions from employees are recorded in the period in which the Company makes payroll deductions. The contributions from the Company, as determined by the latest actuarial valuations, are recorded using the accrual method.

G. Transfers

Transfers to/from other funds are accounted for in the period in which the value of the transfers can be reasonably estimated.

3 Investments

All investments are securities, assets, or financial instruments where the plan's original intention is to hold to maturity or until market conditions render alternative investments more attractive. Significant terms and conditions of investments are as follows:

Bonds, 77% (57% in 1995) of which are issued or guaranteed by Canadian or U.S. governments and 19% (39% in 1995) are issued by supranational agencies, have a market weighted average coupon of 8.6% (8.4% in 1995). Maximum term is 28 years (29 years in 1995) with an average term of 8.4 years (7.3 years in 1995).

Mortgages, secured by real estate, have a market weighted average term of 9.5 years (11.3 years in 1995) and a coupon of 9.9% (10.5% in 1995). Maximum term is 15 years (16 years in 1995).

Equities are diversified by issuer, industry, and by country. Canadian-domiciled companies represent 53% (52% in 1995) of the equity portfolio, and allocations to individual issuers or industry sectors are limited to 2.9% and 9.9% (3.7% and 14.4% in 1995), respectively.

Short-term investments, primarily securities issued by the Government of Canada and Canadian chartered banks, have an average term of 38 days (72 days in 1995) and an average yield of 2.8% (6% in 1995).

Derivatives are financial instruments whose value is derived from interest rates, foreign exchange rates, equity, or commodity prices. Derivatives include forwards, futures, swaps, and options.

From time to time, the CN plans use derivatives in connection with its asset/liability management to hedge foreign exchange, interest rate, or market risks of the portfolio or anticipated transactions.

Notional amounts of derivative contracts were as follows:

In millions	*As at December 31*	1996	1995
Foreign currency risk		$178	$622
Interest rate risk		–	374
		$178	$996

The weighted average term of the above contracts was 2.6 years (1.1 years in 1995). The value of derivative instruments is $2 million ($3 million in 1995) and is included in the value of bonds, which is the asset class hedged.

4 Credit risk

Credit risk arises from the potential for an investee to fail or a counterparty to default on its contractual obligations to the plan.

In accordance with formally established policies, the plan manages credit risk by dealing with counterparties considered to be of high credit quality, utilizing an internal credit limit monitoring process as well as credit mitigation techniques such as master netting and collateral agreements.

At year end, the plan's most significant concentration of credit risk was with the Government of Canada, which issued or guaranteed $2,839 million ($2,437 million in 1995) of securities held by the plan. Excluding the above, the remainder of assets are diversified with no other counterparty accounting for more than 2.1% (2.2% in 1995) of total net assets.

The credit risk of derivative instruments is limited to the cost of replacing, at current market value, all contracts which have a positive value. The following table shows the credit risk of all derivative instruments outstanding at year end.

Credit risk – derivative instruments

In millions *As at December 31*	1996	1995
Maximum exposure	$ 6	$ 8
Less effect of master netting and collateral agreements	(6)	(1)
Net credit risk	$ –	$ 7

5 Funding policy

In respect of the CN Plans, the contributions by the Company are determined in accordance with the requirements of the Pension Benefits Standards Act, 1985 and regulations thereunder and are based on the accrued benefit actuarial cost method, prorated on service, using a projection of salary (also referred to as the projected benefit method prorated on years of service). Consistent with the regulations and in addition to the current service contribution, the Company is making quarterly special payments to liquidate the unfunded actuarial liability by 2010. Also, in the case of the CN 1935 Pension Plan, the Company makes contributions at least equal to those determined by the rules of the plan.

The latest actuarial valuations of the CN Plans were prepared by William M. Mercer Limitée as at December 31, 1995 and were submitted to the Superintendent of Financial Institutions and to Revenue Canada. In these actuarial valuations, the principal assumptions adopted by the Plans' actuary are: members' mortality, disability, retirement, termination of employment, merit, and periodic increases in earnings, as well as a long-term rate of return of 7.5% per annum on investments. Future increases in members' earnings have been projected using economic assumptions consistent with this long-term rate of return.

6 Transfers

In 1996, the accounts include a provision for the amounts to be remitted to/from other funds to cover transfers of members of CN Plans to other pension plans and transfers of members of other plans to the CN Plans.

7 Consolidated actuarial pension obligation and asset value

The actuarial valuations as at December 31, 1995 revealed a consolidated actuarial liability of $8,062 million and a consolidated actuarial asset value of $7,804 million. The results of these valuations were then used to estimate the corresponding figures as at December 31, 1996, which approximate $8,200 million and $8,100 million, respectively, as at that date. The principal components of the change in the pension obligations are the interest accrued on benefits ($600 million in 1996 and 1995), disbursements paid for members ($618 million in 1996 and $607 million in 1995), and benefits accrued during the year ($130 million in 1996 and $150 million in 1995). The consolidated actuarial asset value is based on a market-related method which recognizes the change in market value over a period of five years using the straight-line method.

David G. A. McLean, LL.D.
Chairman of the Board
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Chairman and Chief Executive Officer
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Assumption Life
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Canadian National Railway Company
Montreal, QC
Committees: 3*, 7

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2 Corporate governance
3 Donations
4 Environment and safety
5 Human resources
6 Investment
7 Strategic planning

*denotes chairman of the committee

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P. M. Tellier
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J. P. Ouellet
Chief Legal Officer and Corporate Secretary

S. Pharand
Vice-President and Corporate Comptroller

D. E. Todd
Vice-President
Government Affairs

Annual meeting
The annual meeting of shareholders will be held from 10:30 a.m. to 11:45 a.m. on Monday, May 5, 1997, at The Convention Centre, Edmonton, Alberta.

Annual information form
The annual information form may be obtained by writing to:

The Secretary
Canadian National Railway Company
935 de La Gauchetière Street West
Montreal, Quebec H3B 2M9

Transfer agent and registrar
Montreal Trust Company of Canada

Offices in:
Halifax, NS; Montreal, QC; Toronto, ON; Winnipeg, MB; Calgary, AB; Edmonton, AB; Vancouver, BC

Co-transfer agent and co-registrar
The Bank of Nova Scotia Trust Company of New York
165 Broadway
1 Liberty Plaza
New York, NY 10006

U.S. cash dividend plan
Shareholders wishing to receive dividends in U.S. dollars may obtain detailed information by communicating with:

Montreal Trust Company of Canada
Telephone: (514) 982-7555 or 1-800-527-2221

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Canadian National common shares are listed on the Toronto, New York, and Montreal stock exchanges.

Ticker symbols:
CNR (Toronto stock exchange)
CNI (New York stock exchange)
CNR (Montreal stock exchange)

Investor relations
Robert Noorigian
Vice-President, Investor Relations
Telephone: (514) 399-0052

Shareholder services
Shareholders having inquiries concerning their shares or wishing to obtain information about CN should contact:

Montreal Trust Company of Canada
Shareholder Services
1800 McGill College Avenue
Place Montréal Trust, 6th Floor
Montreal, Quebec H3A 3K9
Telephone: (514) 982-7555 or 1-800-527-2221

Head office
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